



Neutral citation [2014] CAT 14

**IN THE COMPETITION**  
**APPEAL TRIBUNAL**

Case Nos.: 1205/3/3/13  
1206/3/3/13  
1207/3/3/13

Victoria House  
Bloomsbury Place  
London WC1A 2EB

1 August 2014

Before:

THE HONOURABLE MR JUSTICE ROTH  
(President)  
STEPHEN HARRISON  
PROFESSOR COLIN MAYER

Sitting as a Tribunal in England and Wales

BETWEEN:

**BRITISH TELECOMMUNICATIONS PLC**

Appellant: Case No. 1205/3/3/13  
Intervener: Case Nos. 1206-7/3/3/13

**(1) CABLE & WIRELESS WORLDWIDE PLC (2) VIRGIN MEDIA LIMITED**  
**(3) VERIZON UK LIMITED**

Appellants: Case No. 1206/3/3/13  
Interveners: Case No. 1205/3/3/13

**(1) BRITISH SKY BROADCASTING LIMITED (2) TALKTALK TELECOM**  
**GROUP PLC**

Appellants: Case No. 1207/3/3/13  
Interveners: Case No. 1205/3/3/13

- and -

**OFFICE OF COMMUNICATIONS**

Respondent

Heard at Victoria House on  
29, 30 and 31 October 2013, and 1, 4, 5, 6, 7, 8, 14, 15, 21 and 22 November 2013

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**JUDGMENT**

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## APPEARANCES

Mr Rhodri Thompson QC, Mr Graham Read QC, Ms Sarah Lee, Mr Ben Lynch and Ms Georgina Hirsch (instructed by BT Legal) appeared on behalf of the Appellant in Case No. 1205/3/3/13, British Telecommunications PLC.

Ms Dinah Rose QC and Mr Tristan Jones (instructed by Olswang LLP) appeared on behalf of the Appellants in Case No. 1206/3/3/13, (1) Cable & Wireless Worldwide plc, (2) Virgin Media Limited and (3) Verizon UK Limited.

Mr Meredith Pickford and Mr Julian Gregory (instructed by Herbert Smith Freehills LLP) appeared on behalf of the Appellants in Case No. 1207/3/3/13, (1) British Sky Broadcasting Limited and (2) TalkTalk Telecom Group PLC.

Mr Pushpinder Saini QC, Ms Kate Gallafent QC, Mr Hanif Mussa and Ms Emily Neill (instructed by the Legal Department, Office of Communications) appeared on behalf of the Respondent.

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## APPENDIX

## **I. INTRODUCTION AND SUMMARY**

1. This is the judgment of the Tribunal, to which all its members have contributed, in three related appeals brought pursuant to sect 192(2) of the Communications Act 2003 (“the 2003 Act”). All three appeals are against aspects of the determinations of certain disputes by the Office of Communications (“Ofcom”), which are contained in a document entitled “Disputes between each of Sky, TalkTalk, Virgin Media, Cable & Wireless and Verizon and BT regarding BT’s charges for Ethernet services: Determinations and Explanatory Statement” (“the Determination”). The Determination was published on 20 December 2012.

### **A. Ethernet services**

2. As its title makes clear, the Determination dealt with disputes between a number of communications providers (“CPs”) in relation to so-called ‘Ethernet services’. The term ‘Ethernet’ is an international standard for the transmission of data. The Determination dealt specifically with wholesale Ethernet services, i.e. services provided by one CP – in practice British Telecommunications plc (“BT”) – to another, rather than by a CP to an end-user, in the alternative interface symmetric broadband origination (“AISBO”) market. Ethernet services based on AISBO carry many types of data and can be used by CPs to supply their customers with high bandwidth data connectivity. AISBO is one of two forms of symmetric broadband origination, the other being traditional interface symmetric broadband origination or “TISBO”, which does not use an Ethernet interface. Both provide dedicated capacity between two points and are referred to as ‘symmetric’ because they allow data traffic to be carried in both directions along the circuit at the same rate.
3. Openreach, a division of BT,<sup>1</sup> supplies a large number of different Ethernet products to other CPs but the Determination, and therefore these appeals, are concerned with two particular AISBO products: backhaul extension services (“BES”) and wholesale extension services (“WES”). Openreach offers BES and

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<sup>1</sup> Openreach was created in January 2006 following Ofcom’s decision to accept undertakings from BT Group plc in lieu of a market investigation reference to the Competition Commission pursuant to sect 154 of the Enterprise Act 2002. Openreach is an operationally separate business unit, which provides wholesale access telecommunications services to all CPs on an equivalent basis.

WES circuits at a number of different bandwidths, ranging from 10Mbit/s to 10Gbit/s.<sup>2</sup> We set out an overview of BES and WES products at paras 12 to 21 below.

**B. Reviews of the leased lines markets in the UK**

4. On 24 June 2004, Ofcom published the results of its review of the markets for leased lines<sup>3</sup> in a lengthy document called the “Review of the retail leased lines, symmetric broadband origination and wholesale trunk segments markets: Final Statement and Notification” (“the 2004 LLMR”). That review followed the entry into force of a new EU regulatory framework, the so-called Common Regulatory Framework (“CRF”), which comprises five different EU directives, four of which were implemented by the 2003 Act. The CRF requires the designated national regulatory authority (“NRA”) for each EU Member State, among other things, to carry out periodic reviews of the communications markets to ensure that regulation is appropriate for, and proportionate to, the prevailing market conditions. Ofcom is the UK’s NRA.
5. The 2004 LLMR covered a large number of different services, in both the wholesale and the retail leased lines markets. BT was found to have significant market power (“SMP”) on a number of markets. The relevant finding for the purposes of these appeals was that BT held SMP on the market for wholesale AISBO services at all bandwidths in the UK (excluding Kingston-upon-Hull where, for historical reasons, BT does not supply wholesale services). As a result, Ofcom considered it appropriate to impose a number of conditions on BT in the wholesale AISBO market. At the heart of these appeals is Condition HH3.1, which imposed on BT what is commonly referred to as a ‘cost orientation obligation’. It required that BT:

“shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by condition HH1<sup>4</sup> is reasonably derived from the costs of provision based on a

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<sup>2</sup> ‘Mbit/s’ and ‘Gbit/s’ stand for megabits and gigabits per second respectively and are measures of speed of the transfer of digital information. 1 Gbit/s is equivalent to 1000 Mbit/s.

<sup>3</sup> A ‘leased line’ is a “permanently connected communications link between two customer premises, or between a customer’s premises and the CP’s network, dedicated to the customers’ exclusive use.” (Determination, Annex 7: Glossary).

<sup>4</sup> For Condition HH1, see para 40 below.

forward looking long run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed.”

6. In 2008, Ofcom carried out a further periodic review of the leased lines markets and, on 8 December 2008, published the “Business Connectivity Market Review: Review of the retail leased lines, symmetric broadband origination and wholesale trunk segments markets – Statement and Consultation” (“the 2008 BCMR”). By contrast to the 2004 LLMR, in the 2008 BCMR Ofcom defined two different product markets for AISBO: low bandwidth services at speeds up to and including 1Gbit/s and high bandwidth services at speeds over 1Gbit/s. No company was found to have SMP in the high bandwidth market, but Ofcom concluded that BT still held SMP in the low bandwidth market in the UK (excluding Hull). The SMP conditions imposed by the 2004 LLMR were revoked and replaced with effect from 8 December 2008, although Condition HH3.1 was re-imposed in identical terms.

**C. The Disputes and the Determination**

7. Between July 2010 and February 2012, five CPs (collectively, “the Disputing CPs”) referred disputes between them and BT to Ofcom for resolution, pursuant to sect 185(3) of the 2003 Act. Each Disputing CP alleged that BT had breached Condition HH3.1 and overcharged that CP for WES and/or BES products in particular periods. The disputes referred to Ofcom were as follows:

| <b>CP</b>  | <b>Date dispute referred to Ofcom</b> | <b>Service(s) concerned</b> | <b>Period of alleged overcharging</b> |
|--|---------------------------------------|-----------------------------|---------------------------------------|
| British Sky Broadcasting Limited (“Sky”) and TalkTalk Telecom Group plc (“TalkTalk”) jointly | 27 July 2010                          | BES                         | 24 June 2004 to 31 July 2009          |
| Virgin Media Limited (“Virgin”)  | 10 August 2010                        | BES and WES                 | 1 April 2006 to 31 March 2009         |

| CP  | Date dispute referred to Ofcom | Service(s) concerned | Period of alleged overcharging |
|---|--------------------------------|----------------------|--------------------------------|
| Cable & Wireless Worldwide plc group (“CWW”) <sup>5</sup> | 17 November 2011               | BES and WES          | 1 April 2006 to 31 March 2011  |
| Verizon UK Limited (“Verizon”)                            | 22 February 2012               | WES                  | 1 April 2006 to 31 March 2011  |

8. Ofcom decided to accept each of the disputes pursuant to sect 186(3) of the 2003 Act. An appeal by BT against the decision to accept the disputes referred by Sky, TalkTalk and Virgin was dismissed by a differently constituted panel of this Tribunal in a judgment handed down on 3 May 2011.<sup>6</sup>
9. In the Determination, Ofcom concluded that BT had breached Condition HH3.1 and overcharged the Disputing CPs in respect of a number of WES and BES products. Ofcom directed that BT repay to the Disputing CPs the amounts overcharged, which it calculated totalled £94.8m, but Ofcom declined to direct that BT pay interest on the overcharged amounts.

#### **D. The appeals**

10. All the parties to the disputes lodged appeals against the Determination pursuant to sect 192(2) of the 2003 Act, although the extent of those appeals varies significantly. Sky and TalkTalk had submitted their dispute to Ofcom jointly and they similarly lodged a joint appeal. Virgin, CWW and Verizon also lodged a joint appeal and have been referred to in these proceedings as “the Altnets”.
11. By an Order made on 18 March 2013, it was directed that the three appeals be heard together. BT was given permission to intervene in the two other appeals, and the Disputing CPs were given permission to intervene in BT’s appeal. It was also directed that the issue of what rate of interest should apply, in the event that the Disputing CPs were successful in their contention that interest should be awarded, would be adjourned to be considered subsequently. The Tribunal duly heard

<sup>5</sup> Ofcom notes at fn 1 to the Determination that there are in fact a number of companies within the Cable & Wireless group of companies to which the dispute referred by CWW applies.

<sup>6</sup> *British Telecommunications plc v Office of Communications* [2011] CAT 15. BT did not seek to appeal Ofcom’s later decisions to accept the disputes referred to it by CWW and Verizon.

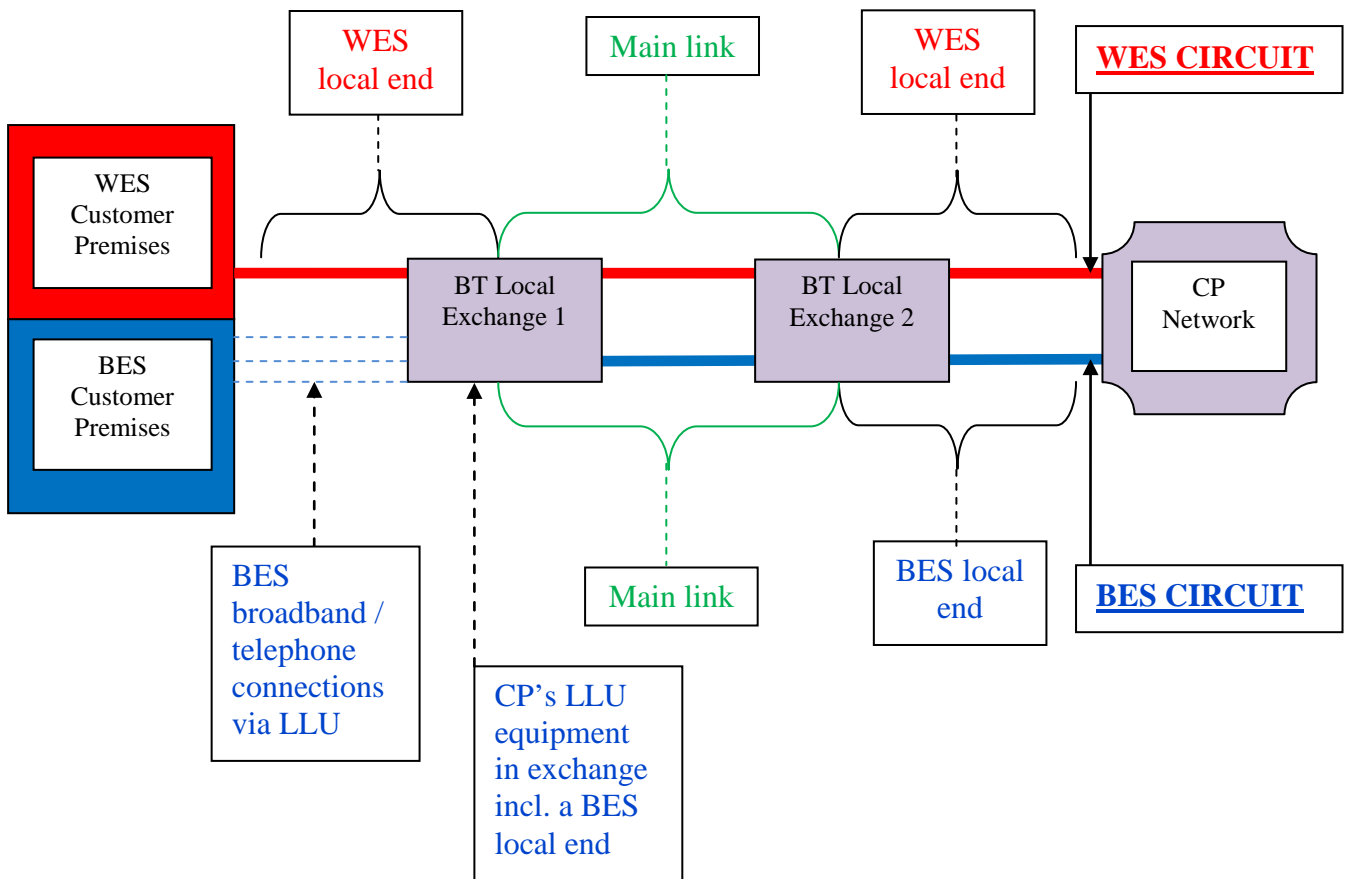
submissions and evidence (both factual and expert) in all three appeals over 13 days between 29 October and 22 November 2013.

## **II. SERVICES IN DISPUTE**

12. As is clear from the table set out at para 7 above, the referred disputes concerned the purchase of different AISBO services from BT. The Sky and TalkTalk dispute concerned only BES, the Verizon dispute concerned only WES, while the Virgin and CWW disputes concerned both services. WES and BES serve different purposes, and the extent to which either is required depends on the profile of a CP's own business and network. What follows is a necessarily simplified description of these highly technical products, as well as certain related products and services. It is based, in part, on a very helpful annex to the first witness statement of BT's Mr William Jones, which was not challenged.
13. A WES circuit connects an end-user's premises to a CP's network via BT's network. The circuit will run from the CP's point of presence ("PoP") to the premises of the end-user, who will be the CP's customer. WES circuits are principally used by closed-user groups (i.e. only identified users or groups of users) for connections to customer premises, predominantly in sectors such as finance and media. A WES circuit might be used, for example, to connect the different offices of a bank. WES circuits were designed to cover distances of up to 25km between the end-user site and the CP's PoP.
14. By contrast, a BES circuit does not provide any connection to the end-user's premises. Rather, a BES circuit is used to provide a backhaul link between a CP's customer-serving equipment in a local BT exchange and that CP's PoP in another BT exchange or the CP's core network. Thus, BES are used by local loop unbundling ("LLU") operators, which install their equipment in a BT local exchange and then rent from BT the copper lines that run from that exchange to the relevant customer's premises, enabling the operator to provide its customers with telephony and/or broadband services.



15. Over time, BT's AISBO offerings have become more complicated and there are now a number of product variants. But Mr Jones illustrated the difference between the original WES and BES products in diagrammatic form and we consider it useful, in simplified form, to do the same:



16. As Ofcom explained in the Determination,<sup>7</sup> WES and BES circuits will include so-called 'local ends' and may also require a 'main link'. As can be seen above, in a BES circuit, the local ends connect a CP's equipment installed in a BT exchange to the CP's core network; whereas in a WES circuit, the local ends connect a customer's premises to a BT local exchange, as well as that exchange to the CP's core network. Where a circuit (whether WES or BES) passes through more than one BT local exchange, however, the CP will also require a 'main link' from BT to connect those two exchanges. In the diagram above, the main link connects BT Local Exchange 1 to BT Local Exchange 2.

<sup>7</sup> See Determination, paras 6.7-6.11.

17. We have referred to CPs ‘buying’ AISBO services from BT, or to Openreach ‘supplying’ or ‘offering’ AISBO services. It is necessary to say something about the manner in which this occurs, since it is the charges for AISBO services levied by BT that are the subject of the disputes.
18. At its simplest, when a CP requires a WES or BES circuit for its business, it requests one from BT by completing a form that incorporates various standard terms and conditions. A BT engineer will then visit the site, or sites, in question, install the necessary equipment and ‘connect’ the circuit. For this, the CP incurs a one-off connection charge. In addition, the CP is required to pay a rental charge for the circuit. The minimum contract term for a circuit is one year. Thus, a CP requesting a new circuit from BT will be required to pay the connection charge and a year’s rental. Where a main link is also required for a particular circuit, this will be charged by the metre on a rental basis based on the radial distance between the two exchanges, with a maximum distance of 25km.
19. Beyond the minimum term, a CP is not required to commit to a particular duration for a circuit and it will simply continue to pay the rental charge to BT until it no longer requires the circuit in question. At that point, it will give the necessary notice to BT and the circuit will terminate. Some of the installed equipment can be re-used and a BT engineer will remove that equipment.
20. There are a number of other charges levied by BT, depending on the circumstances. Two are of relevance to this case:
  - (a) Migration charge: WES is the successor product to an earlier, and now obsolete, service offered by BT known as ‘LES’ (LAN<sup>8</sup> Extension Services). When LES were discontinued, those CPs with existing LES circuits, and which had already paid a connection charge for those circuits, could pay a ‘migration charge’ to migrate those legacy circuits to the WES platform. The migration charge was a fraction of a WES connection charge and was intended to reflect the administrative cost to BT of making the necessary changes in its records and billing systems for the CP.

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<sup>8</sup> ‘LAN’ stands for Local Area Network.

- (b) Excess construction charges (“ECCs”): BT will levy an extra charge, the ECC, where installation requires extra work to connect the circuit, e.g. because new fibre must be added, or because the CP’s customer requires the works to be done out of normal business hours.
21. All the various charges that a CP might incur when establishing a new circuit, and subsequently maintaining it, are set out in BT’s Openreach Price List (“the OPL”). The charges vary by reference to the type of service (for present purposes BES or WES), the required bandwidth (from 10Mbit/s to speeds in excess of 1Gbit/s), whether a main link is necessary and whether there are any supplementary charges, such as ECCs. For example, the OPL sets out the one-off connection and annual rental charges that a CP would pay for a WES 10 circuit or a BES 1000 circuit (i.e. a WES circuit with a speed of 10Mbit/s and a BES circuit with a speed of 1Gbit/s). Throughout this judgment, we will refer to circuits on this basis.

### **III. THE CRF AND THE 2003 ACT**

22. As noted above, the basis for the regulation of the AISBO market in the UK is the CRF, as implemented by the 2003 Act. The CRF comprises a Framework Directive, Dir. 2002/21/EC, and four “Specific Directives”. For present purposes, the two relevant Specific Directives are the Access Directive, Dir. 2002/19/EC, and the Authorisation Directive, Dir. 2002/20/EC. Aspects of the directives comprising the CRF were amended by Dir. 2009/140/EC, and the 2003 Act was amended to implement these changes by the Electronic Communications and Wireless Telegraphy Regulations 2011, with effect from 26 May 2011. Navigating the interrelated provisions of the different directives in the CRF is not always easy.
23. Pursuant to sect 3(1) of the 2003 Act, Ofcom’s principal duty is to further the interests of citizens in relation to communications matters, and to further the interests of consumers in relevant markets, where appropriate by promoting competition.
24. Further, in performing the duties under the 2003 Act relevant to this case, Ofcom is required by sect 4 to act in accordance with the “six Community requirements”,

set out in subsections (3) to (9). Those give effect, among other things, to Art 8 of the Framework Directive, which sets the policy objectives and regulatory principles applicable under the CRF. The six Community requirements, in summary, are to:

- (a) promote competition;
- (b) secure that Ofcom's activities contribute to the development of the European internal market;
- (c) promote the interests of all EU citizens;
- (d) take account of the desirability, so far as possible, of Ofcom carrying out its functions in a way that does not favour only one form of electronic communications network or service, or one means of making available that network or service;
- (e) encourage the provision of network access and service interoperability; and
- (f) encourage compliance with certain standards set out in sect 4(10) of the 2003 Act.

25. The first requirement is a reflection of Art 8(2) of the Framework Directive, which prescribes, insofar as relevant:

“2. The national regulatory authorities shall promote competition in the provision of electronic communications networks, electronic communications services and associated facilities and services by inter alia:

- (a) ensuring that users ... derive maximum benefit in terms of choice, price, and quality;
- (b) ensuring that there is no distortion or restriction of competition in the electronic communications sector;
- (c) encouraging efficient investment in infrastructure, and promoting innovation ...”<sup>9</sup>

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<sup>9</sup> As part of the package of amendments to the directives comprising the CRF brought about by Dir. 2009/140/EC, Art 8(2)(c) of the Framework Directive, as quoted here, was effectively transposed to a new Art 8(5)(d).

## *SMP Obligations*

26. Pursuant to Art 16 of the Framework Directive, each NRA is required to carry out an analysis defining relevant markets and identifying undertakings with SMP on any market that is found not to be effectively competitive. Once an operator has been so designated as having SMP on a specific market, the NRA must impose on it one or more of the obligations set out in Arts 9-13 of the Access Directive, “as appropriate”: see Art 8(2) of the Access Directive. Those obligations are therefore referred to as “SMP obligations” or “SMP conditions”. For example, Art 12 sets out SMP obligations regarding access to and use of network facilities.
27. For present purposes, the SMP obligations of particular relevance are those set out in Art 13 of the Access Directive. Insofar as material, this provides as follows:

### *“Article 13*

#### **Price control and cost accounting obligations**

1. A national regulatory authority may, in accordance with the provisions of Article 8, impose obligations relating to cost recovery and price controls, including obligations for cost orientation of prices and obligations concerning cost accounting systems, for the provision of specific types of interconnection and/or access, in situations where a market analysis indicates that a lack of effective competition means that the operator concerned might sustain prices at an excessively high level, or apply a price squeeze, to the detriment of end-users. National regulatory authorities shall take into account the investment made by the operator and allow him a reasonable rate of return on adequate capital employed, taking into account the risks involved.<sup>10</sup>

2. National regulatory authorities shall ensure that any cost recovery mechanism or pricing methodology that is mandated serves to promote efficiency and sustainable competition and maximise consumer benefits. In this regard national regulatory authorities may also take account of prices available in comparable competitive markets.

3. Where an operator has an obligation regarding the cost orientation of its prices, the burden of proof that charges are derived from costs including a reasonable rate of return on investment shall lie with the operator concerned. For the purpose of calculating the cost of efficient provision of services, national regulatory authorities may use cost accounting methods independent of those used by the undertaking.

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<sup>10</sup> As amended by Dir. 2009/140/EC, the second sentence of Art 13(1) now reads: “To encourage investments by the operator, including in next generation networks, national regulatory authorities shall take into account the investment made by the operator, and allow him a reasonable rate of return on adequate capital employed, taking into account any risks specific to a particular new investment network project.” It was not suggested, however, that this change made any material difference in the present cases.

National regulatory authorities may require an operator to provide full justification for its prices, and may, where appropriate, require prices to be adjusted.”

28. The provisions of the CRF concerning SMP conditions have been implemented in the UK by sects 45-49 and 87-88 of the 2003 Act. Specifically as regards SMP conditions for price control and cost accounting, sects 87(9) and 88 provide, insofar as material:<sup>11</sup>

**“87 Conditions about network access etc.**

...

(9) The SMP conditions authorised by this section also include (subject to section 88) conditions imposing on the dominant provider—

(a) such price controls as OFCOM may direct in relation to matters connected with the provision of network access to the relevant network, or with the availability of the relevant facilities;

(b) such rules as they may make in relation to those matters about the recovery of costs and cost orientation ...

**88 Conditions about network access pricing etc.**

(1) OFCOM are not to set an SMP condition falling within section 87(9) except where—

(a) it appears to them from the market analysis carried out for the purpose of setting that condition that there is a relevant risk of adverse effects arising from price distortion; and

(b) it also appears to them that the setting of the condition is appropriate for the purposes of—

(i) promoting efficiency;

(ii) promoting sustainable competition; and

(iii) conferring the greatest possible benefits on the end-users of public electronic communications services.

(2) In setting an SMP condition falling within section 87(9) OFCOM must take account of the extent of the investment in the matters to which the condition relates of the person to whom it is to apply.

(3) For the purposes of this section there is a relevant risk of adverse affects arising from price distortion if the dominant provider might—

(a) so fix and maintain some or all of his prices at an excessively high level, or

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<sup>11</sup> The particular provisions quoted here were not amended by the Electronic Communications and Wireless Telegraphy Regulations 2011.

(b) so impose a price squeeze,

as to have adverse consequences for end-users of public electronic communications services.

(4) In considering the matters mentioned in subsection (1)(b) OFCOM may—

(a) have regard to the prices at which services are available in comparable competitive markets;

(b) determine what they consider to represent efficiency by using such cost accounting methods as they think fit.”

29. The purpose of the Art 13 SMP conditions is addressed in Recital (20) of the Access Directive, which states:

“Price control may be necessary when market analysis in a particular market reveals inefficient competition. The regulatory intervention may be relatively light, such as an obligation that prices for carrier selection are reasonable as laid down in Directive 97/33/EC, or much heavier such as an obligation that prices are cost oriented to provide full justification for those prices where competition is not sufficiently strong to prevent excessive pricing. In particular, operators with significant market power should avoid a price squeeze whereby the difference between their retail prices and the interconnection prices charged to competitors who provide similar retail services is not adequate to ensure sustainable competition. When a national regulatory authority calculates costs incurred in establishing a service mandated under this Directive, it is appropriate to allow a reasonable return on the capital employed including appropriate labour and building costs, with the value of capital adjusted where necessary to reflect the current valuation of assets and efficiency of operations. The method of cost recovery should be appropriate to the circumstances taking account of the need to promote efficiency and sustainable competition and maximise consumer benefits.”

#### *Dispute Resolution*

30. The operative provision of the CRF governing the resolution by an NRA of disputes between CPs is Art 20 of the Framework Directive, which provides as follows, insofar as material:

*“Article 20*

#### **Dispute resolution between undertakings**

1. In the event of a dispute arising in connection with obligations arising under this Directive or the Specific Directives between undertakings providing electronic communications networks or services in a Member State, the national regulatory authority concerned shall, at the request of either party, issue a binding decision to resolve the dispute in the shortest possible time frame and in any case within four

months except in exceptional circumstances. The Member State concerned shall require that all parties cooperate fully with the national regulatory authority.<sup>12</sup>

...

3. In resolving a dispute, the national regulatory authority shall take decisions aimed at achieving the objectives set out in Article 8. Any obligations imposed on an undertaking by the national regulatory authority in resolving a dispute shall respect the provisions of this Directive or the Specific Directives.

...

5. The procedure referred to in paragraphs 1, 3 and 4 shall not preclude either party from bringing an action before the courts.”

31. This provision concerning dispute resolution has been implemented in the UK by sects 185-191 of the 2003 Act.
32. The purpose of those provisions is set out in Recital (32) to the Framework Directive:

“In the event of a dispute between undertakings in the same Member State in an area covered by this Directive or the Specific Directives, for example relating to obligations for access and interconnection or to the means of transferring subscriber lists, an aggrieved party that has negotiated in good faith but failed to reach agreement should be able to call on the national regulatory authority to resolve the dispute. National regulatory authorities should be able to impose a solution on the parties. The intervention of a national regulatory authority in the resolution of a dispute between undertakings providing electronic communications networks or services in a Member State should seek to ensure compliance with the obligations arising under this Directive or the Specific Directives.”

#### **IV. REGULATION OF AISBO SERVICES**

33. On 3 July 2003, a CP called Energis submitted a dispute to the Director General of Telecommunications (“Of tel”) under the then regime for dispute resolution set out in the Telecommunications (Interconnection) Regulations 1997 (“the 1997 Regulations”). Energis complained, inter alia, about BT’s refusal to provide a wholesale variant of its shorthaul data services. These were BT’s LES products,

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<sup>12</sup> As amended pursuant to Dir 2009/140/EC, the first sentence of Art 20(1) begins: “In the event of a dispute arising in connection with *existing* obligations under this Directive or the Specific Directives between undertakings providing electronic communications networks or services in a Member State ...” [emphasis added]. BT’s application, made after the conclusion of the hearing of these cases, to amend its Notice of Appeal to introduce a new ground of appeal, alleging that dispute resolution could cover only obligations current at the time of the dispute, was dismissed: see Ruling handed down on 11 March 2014: [2014] CAT 4.



with which Energis wished to compete at the retail level. Shortly afterwards, the 1997 Regulations were replaced by the 2003 Act and, at the end of 2003, Ofcom assumed the powers of Oftel. The Energis complaint was thereafter considered by Ofcom pursuant to the dispute resolution provisions of the 2003 Act.

34. As mentioned above, pursuant to the CRF, implemented in the UK by the 2003 Act, NRAs are required to carry out periodic reviews of competition in communications markets, to determine what regulation, if any, is appropriate in the light of changing market conditions. Oftel accordingly commenced a review in 2003 of the retail leased lines, symmetric broadband origination and wholesale trunk segment markets (“the leased lines market review”). That review was carried forward by Ofcom, when it took over from Oftel, and resulted in the 2004 LLMR published on 24 June 2004.
35. It was in the context of the leased lines market review that a wholesale AISBO market was first identified. Ofcom found that this was a single product market across all bandwidths and that, geographically, the UK was a single market except that, for largely historical reasons, the Kingston-upon-Hull area had different competitive conditions such that it formed a distinct market. Since the wholesale product requested by Energis fell within the scope of that AISBO market, resolution of the Energis complaint was delayed pending the outcome of the market review.
36. As stated above, Ofcom found in the 2004 LLMR that BT had SMP in that market in the UK (except for the Hull area, where Kingston Communications plc (“Kingston”) had SMP), and concluded that it was appropriate to impose a number of SMP conditions in the light of the market conditions it had observed. The SMP conditions included a network access condition, a non-discrimination obligation, a cost orientation obligation and cost accounting obligations.
37. As already explained, AISBO services are to be distinguished from TISBO services, which do not use an Ethernet interface.<sup>13</sup> A significant form of TISBO services are the terminating segments of so-called Partial Private Circuits

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<sup>13</sup> For the differences between AISBO and TISBO services, see 2004 LLMR at paras 1.43-1.45.

(“PPCs”), which provide transmission capacity from the point of connection between two CPs’ networks and the premises of the customer of one of those CPs. Ofcom found that for TISBO, low bandwidth (up to and including 8 Mbit/s) and high bandwidth (above 8 Mbit/s up to and including 155 Mbit/s) services were distinct markets, and that BT had SMP in both those TISBO markets in the UK (except in the Hull area), while Kingston had SMP in those markets in Hull. BT was also found to have SMP in the market for wholesale trunk segments at all bandwidths (including, unusually, the Hull area). Ofcom imposed broadly the same package of SMP conditions as regards TISBO services and wholesale trunk segments as for AISBO services, save that for TISBO a charge control obligation was, in addition, imposed on BT.

38. As regards the SMP conditions imposed on BT in the AISBO market, Ofcom described its overall approach in the 2004 LLMR as follows:

“7.10 Regulation at the wholesale level is designed to address the problems which result from the existence of SMP in the relevant wholesale market. In particular it is designed to ensure that the SMP at the wholesale level does not restrict or distort competition in the relevant downstream markets or operate against the interests of consumers, for example through excessively high prices ...

7.11 The application of regulation at the wholesale level also fits with the requirements of the Framework Directive, that NRAs take measures which are proportionate to the objective of encouraging efficient investment in infrastructure and promoting innovation. The introduction of regulation in wholesale markets will encourage communications providers to purchase wholesale products and combine them with their own networks where possible to create retail products in competition with BT’s retail leased lines products and other services. This is preferable to retail regulation alone, which would by contrast tend to favour the purchase of BT’s retail products and thereby lessen other communications providers’ investment in infrastructure and, through less competition, innovation.”

39. Specifically as regards the imposition of the cost orientation condition, Ofcom stated:

“7.61 Ofcom considers that the cost orientation condition is justifiable and a proportionate response to the extent of competition in the markets analysed. It enables competitors to purchase services at a rate which will enable them to develop competitive services to the benefit of consumers, whilst at the same time allowing BT a fair rate of return which it would expect in a competitive market. The potential for a degree of flexibility envisaged in the approach to the recovery of cost of capital recognises that some investments will carry a higher degree of risk than others and does not remove incentives for the development of new services.”

Ofcom made clear that, in terms of price distortion, the adverse effect of which it considered that there was a risk, for the purpose of sect 88(1)(a) and (3) of the 2003 Act, was excessive pricing by BT: see at para 7.68. It did not rely on any risk of a price squeeze.

40. In relation to the AISBO market, the network access requirement was prescribed as Condition HH1 and the cost orientation requirement as Condition HH3:

**Condition HH1 - Requirement to provide network access on reasonable request**

HH1.1 Where a Third Party reasonably requests in writing Network Access, the Dominant Provider shall provide that Network Access. The Dominant Provider shall also provide such Network Access as Ofcom may from time to time direct.

HH1.2 The provision of Network Access in accordance with paragraph HH1.1 shall occur as soon as reasonably practicable and shall be provided on fair and reasonable terms, conditions and charges and on such terms, conditions and charges as Ofcom may from time to time direct.

...

**Condition HH3 - Basis of charges**

HH3.1 Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by Condition HH1 is reasonably derived from the costs of provision based on a forward looking long run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed.

HH3.2 The Dominant Provider shall comply with any direction Ofcom may from time to time direct under this Condition.”

41. To supplement the cost orientation obligations imposed in both the AISBO and TISBO markets, and the charge control obligation on BT in the TISBO markets, Ofcom proposed the imposition of cost accounting obligations, which it explained as follows:

“10.10 Given the imposition of LRIC with an appropriate mark-up for the recovery of common costs on both BT and Kingston, and a charge control for BT, Ofcom is proposing that BT and Kingston should maintain appropriate cost accounting systems, that demonstrate that the obligations of cost orientation and (for BT) the charge control are being met. This will enable Ofcom to monitor compliance with those obligations.”

And further:

“10.13 In order to demonstrate cost orientation of a service or product, it is necessary for the dominant provider to establish cost accounting systems that capture, identify, value and attribute relevant costs to its services and products in accordance with agreed regulatory accounting principles, such as cost causality. A key part of this process is the stage which identifies those parts of the underlying activities or elements that directly support or are consumed by those services or products. These elements are referred to as network components. As these components are frequently used to provide more than one product or service, it is also necessary to determine how much of each component is used for each service or product that should be cost-oriented. The service/product costing methodology applies the utilisation of these components (which are characterised by common usage measures) to the appropriate service product.”

42. The cost accounting obligations were not, however, set by the 2004 LLMR but by a separate document issued about a month later, “The Regulatory Financial Reporting obligations on BT and Kingston Communications: Final statement and notification” (the “2004 Financial Reporting Notification”). This imposed on BT 34 further SMP conditions, known as OA1 to OA34. For present purposes, it is sufficient to quote from only three of them:

“OA2 Ofcom may from time to time make such directions as they consider appropriate in relation to BT’s Cost Accounting System, Accounting Separation System and its obligations under these conditions.

OA3 BT shall comply with any direction Ofcom may make from time to time under these conditions.

...

OA5 BT shall in respect of the Market, Technical Areas and the Disaggregated Activities (as applicable) for each Financial Year:

a. prepare such Regulatory Financial Statements as directed by Ofcom from time to time in accordance with the Accounting Documents (the relevant Accounting Documents to be identified in the Regulatory Financial Statements by reference to their date);

...

d. publish the Regulatory Financial Statements and corresponding audit opinion as directed by Ofcom from time to time and in accordance with condition OA6(b) and (c) ...”

43. Pursuant to OA6(b), BT was required to publish its Regulatory Financial Statements (“RFS”) within 4 months after the end of the period to which they relate. The RFS relate to BT’s financial years, which end on 31 March. BT was

required, therefore, to publish its RFS for each financial year by not later than 31 July in the following financial year.

44. The OA conditions set by the 2004 Financial Reporting Notification did not prescribe the precise information that BT's RFS were to contain: instead, the detail was set out in certain directions annexed to the 2004 Financial Reporting Notification.
45. The financial information that BT was required to produce and publish comprised a significant package of material in addition to the RFS itself. The information comprised what were called the Primary Accounting Documents ("PAD") and the Secondary Accounting Documents, which included detailed attribution methods, detailed valuation methodology and BT's Long Run Incremental Cost ("LRIC") model, that were used to prepare the RFS. The RFS was prepared on a Current Cost Accounting ("CCA") basis<sup>14</sup> and set out, among other data, the revenues, volumes, fully allocated cost ("FAC"), distributed long run incremental cost ("DLRIC"),<sup>15</sup> and distributed stand alone cost ("DSAC")<sup>16</sup> for services that are subject to cost orientation obligations. We explain these costs concepts at para 74 below.
46. Mr Edward Dolling, Director of BT's Group Regulatory Finance Department, explained in his evidence that in developing the financial reporting information, considerable consultation took place between Ofcom and BT as to the nature and format of these documents. Both BT and Ofcom continually reviewed the methodologies to ensure that they were appropriate. Therefore, the reporting regime was dynamic: as changes occurred (technical, structural, new products, new markets or improved methodologies for allocating costs), changes could be made to the RFS. In the first instance, the impact would be determined internally within BT, but any changes had to be reviewed and agreed by Ofcom.

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<sup>14</sup> CCA is an "accounting convention, where assets are valued and depreciated according to their current replacement costs whilst maintaining the operating or financial capital of the business entity." (see Determination, Annex 6, A6.2.).

<sup>15</sup> Referred to in the RFS as the unaudited LRIC floor.

<sup>16</sup> Referred to as the unaudited LRIC ceiling.

47. Further, Ofcom established a practice whereby it reviewed the detailed reporting requirements on an annual basis, taking account of regulatory developments in the year, put out a consultation document to the whole industry at, or around, the end of BT's financial year, and then issued a statement making the necessary changes or updates to be adopted by BT in the forthcoming RFS. This meant that, notwithstanding the four-month limit for publication fixed by OA6(b), BT could not finalise its RFS for the year-ended 31 March until sometime after Ofcom notified it of the changes to its reporting obligations.<sup>17</sup> Mr Dolling said that it took at least 10 working days, from publication by Ofcom, merely to read and seek any necessary clarifications on the explanatory statement and notification, and that it then might require weeks to implement in the RFS, depending on the magnitude of changes. Accordingly, there is a significant time lag between the end of a financial year and the publication of the RFS, the primary document by reference to which compliance with BT's cost orientation obligations can be assessed by Ofcom or considered by another CP.
48. On 3 September 2004, a little over two months after issuing the 2004 LLMR, Ofcom issued its determination of the Energis dispute (see para 33 above). It noted that the obligation, imposed by the 2004 LLMR to provide network access would cover the products sought by Energis. Accordingly, pursuant to the SMP obligations imposed by the 2004 LLMR, BT was obliged to provide network access to those products. In its formal determination of the Energis dispute, Ofcom directed BT to provide Energis with wholesale variants of the LES products (i.e. WES products) on cost-oriented terms.
49. On 8 December 2008, Ofcom published a further review of the retail leased lines, wholesale symmetric broadband origination and wholesale trunk segment markets: the 2008 BCMR, to which we referred above. The 2008 BCMR expressly superseded the 2004 LLMR. In the 2008 BCMR, Ofcom defined two separate markets for wholesale AISBO services:

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<sup>17</sup> The precise date on which Ofcom published the requisite explanatory statement and notification varies from year to year: for the 2005/06 financial year, it was published on 16 August 2006; 2006/07, 30 May 2007; 2007/08, 26 June 2008; 2008/09, 15 June 2009; 2009/10, 4 June 2010; and 2010/11, 2 June 2011.

- (a) low bandwidth AISBO, for services up to and including 1 Gbit/s; and
- (b) high bandwidth AISBO, for services with bandwidths above 1 Gbit/s.

50. Ofcom found that BT had SMP in the low bandwidth market (excluding Hull):

“1.28 ... This conclusion is based primarily on BT’s persistently high market share (73% by volume in 2006); the high profitability of the relevant services (around 30% Return on Capital Employed in 2007/08); the advantages enjoyed by BT due to its much more extensive network infrastructure; and the barriers to entry and expansion in this market, which are associated with high sunk costs and the availability of economies of scale and scope.”

However, it found that no operator had SMP in the high bandwidth AISBO market. Ofcom noted:

“1.29 ... While still relatively high at around 38% to 40%, BT’s market share has been falling and there is no evidence to indicate that this trend will reverse in the near future. In addition, there has been significant entry in the market in the recent past, and we are aware of likely future entry. The evidence suggests that the very high revenues that can be earned from these circuits mean that CPs are generally willing to sink the high fixed costs required to provide them.”

51. In turning to remedies, Ofcom stated the following:

“1.39 We have decided to impose a range of obligations on BT and [Kingston] in the markets in which they have been found to have SMP. While the obligations are in many respects similar to those imposed following the 2003/04 Review, there are a number of significant changes, including:

The proposed extension of charge controls to cover low bandwidth AISBO and TI trunk services, in addition to low and high bandwidth TISBOs. In proposing a charge control for low bandwidth AISBO services, we have taken account of the fact that this is now a mature market, in which BT has a position of persistent dominance and is earnings [sic] high returns. BT’s returns in the trunk market have also been high and, contrary to our expectations at the time of the 2003/04 review, this market has not become increasingly competitive over time ...”

52. The SMP conditions imposed by the 2004 LLMR were formally revoked and new SMP conditions were imposed by Schedule 4 to the 2008 BCMR. However, the cost orientation obligation in HH3.1 was re-imposed in identical terms on low

bandwidth AISBO services, with the addition of a paragraph making clear that HH3.1 applied also where the charge is for a service subject to charge control.<sup>18</sup>

53. The terms of the new charge control condition were subject to a separate consultation, and then imposed through the Leased Lines Charge Control Statement<sup>19</sup> published on 2 July 2009 (“the 2009 LLCC”). The charge control was in the form of RPI-X, imposed on baskets of charges, using CCA FAC as the relevant cost standard. BT’s main AISBO connection and rental charges formed one of the six main baskets within this charge control. Ofcom explained that it regarded RPI-X as preferable to a cost-plus form of charge control, which would give BT little incentive to keep its costs under control since its profit margin would then be the same irrespective of the costs incurred. Ofcom also set out its view as to the interrelationship of cost orientation and charge control in the 2009 LLCC:

“4.14 ... Charge controls and cost orientation obligations are complementary in that the former restricts BT’s pricing flexibility at a basket level whilst the latter ensures that BT sets its individual prices within some reasonable bounds.”

## V. THE DETERMINATION

54. As stated above, the disputes referred to Ofcom that resulted in the Determination alleged that BT was overcharging for Ethernet services in breach of Condition HH3.1. The disputes related to different, but overlapping, periods and to particular BES and/or WES products that the disputing CPs had purchased from BT: see the Table at para 7 above.
55. On 8 February 2012, Ofcom issued a draft determination setting out its provisional conclusions in the disputes submitted by Sky/TalkTalk and Virgin, followed a few weeks later by a draft determination of the dispute submitted by CWW. On 4 April 2012, Ofcom issued its provisional conclusions in the dispute submitted by Verizon. The parties were given until 20 April to make submissions on the

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<sup>18</sup> “HH3.2 For the avoidance of any doubt, where the charge offered, payable or proposed for Network Access covered by Condition HH1 is for a service which is subject to a charge control under Condition HH4, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that such a charge satisfies the requirement of Condition HH3.1.”

<sup>19</sup> The full title of this document was: “Leased Lines Charge Control: A new charge control framework for wholesale traditional interface and alternative interface products and services – Statement”.



provisional conclusions in the first three disputes, and until 23 April as regards the Verizon dispute. These documents from Ofcom are referred to collectively as the “Provisional Conclusions.” All the parties submitted written responses to the Provisional Conclusions, and in May 2012 Ofcom provided a non-confidential version of the responses of the Disputing CPs. That was followed by meetings between Ofcom and BT, at BT’s request, and further written representations by BT on 3 September 2012. The final determination was delayed because Ofcom decided it was appropriate to wait until the Court of Appeal handed down its judgment in the *PPC* case. Following the issue of that judgment on 27 July 2012, each of the parties submitted representations to Ofcom in August 2012 as to the impact of the judgment on the present disputes and the Provisional Conclusions.

56. The Determination is a very substantial document, divided into 15 chapters (“sections”), comprising 430 pages, followed by seven annexes.
  
57. After a summary and sections setting out the legal framework, the nature of the disputes and the factual background, Ofcom considered what charges were required to be cost oriented in accordance with Condition HH3.1 (sect 8). It then discussed the appropriate approach to the determination of whether those charges were cost oriented and the use of DSAC<sup>20</sup> for that purpose (sect 9). Next, it considered, in accordance with Condition HH3.1, whether BT could demonstrate (to Ofcom’s satisfaction) that the disputed charges were cost oriented (sect 10). Having concluded that BT was unable to do so, Ofcom proceeded to consider itself whether those charges were in fact cost oriented. In that regard, it first addressed as a matter of principle what data should be used for that purpose (sect 11). Then Ofcom analysed the appropriate data to be used to determine the DSAC of the various charges, having regard to the change in methodology during the relevant period adopted by BT (sect 12). Ofcom next addressed in detail the various proposed adjustments to BT’s cost and revenue figures, explaining the adjustments it had decided to make and the proposed adjustments which it had rejected (sect 13).

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<sup>20</sup> For the meaning of DSAC, see para 74 below.

58. For each disputed Ethernet charge in each relevant year, Ofcom then assessed and determined whether the charge was in fact cost oriented and if not, the amount overcharged (sect 14). Ofcom concluded that BT had overcharged for the following BES and WES services in the years 2005/06 to 2010/11:<sup>21</sup>

| <b>Ethernet service</b> | <b>2006/07</b> | <b>2007/08</b> | <b>2008/09</b> | <b>2009/10</b> | <b>2010/11</b> |
|-------------------------|----------------|----------------|----------------|----------------|----------------|
| BES100 Rental           | Yes            | Yes            | Yes            | Yes            | No             |
| BES1000 Rental          | Yes            | Yes            | Yes            | Yes            | No             |
| BES155 Rental           | Yes            | Yes            | Yes            | Yes            | Yes            |
| BES622 Rental           | Yes            | Yes            | Yes            | Yes            | Yes            |
| BES2500 Rental          | NiD            | NiD            | Yes            | NiD            | NiD            |
| BES10000 Rental         | NiD            | NiD            | Yes            | NiD            | NiD            |
| BES100 Connection       | Yes            | Yes            | No             | No             | NiD            |
| BES1000 Connection      | Yes            | No             | No             | No             | NiD            |
| WES10 Rental            | No             | No             | Yes            | No             | No             |
| WES100 Rental           | Yes            | Yes            | Yes            | Yes            | No             |
| WES1000 Rental          | Yes            | Yes            | Yes            | Yes            | Yes            |
| WES155 Rental           | Yes            | Yes            | Yes            | Yes            | Yes            |
| WES622 Rental           | Yes            | Yes            | Yes            | Yes            | Yes            |
| WES10000 Rental         | NiD            | Yes            | Yes            | NiD            | NiD            |

59. As stated above, Ofcom determined that the total amount of the overcharge was £94.8 million. This broke down as between the five years as follows:<sup>22</sup>

| <b>Year</b> | <b>Amount of overcharge (in GBP)</b> |
|-------------|--------------------------------------|
| 2006/07     | 23,657,000                           |
| 2007/08     | 33,427,000                           |
| 2008/09     | 30,994,000                           |

<sup>21</sup> Adapted from Tables 1.2 and 14.22 in the Determination. “NiD” stands for ‘not in dispute’.

<sup>22</sup> Adapted from Table 1.3 in the Determination.

|              |                   |
|--------------|-------------------|
| 2009/10      | 6,162,000         |
| 2010/11      | 583,000           |
| <b>Total</b> | <b>94,823,000</b> |

60. Finally, Ofcom resolved that BT should repay the full amount of the overcharges to the respective Disputing CPs but that BT should not pay interest on those amounts (sect 15). The latter conclusion was based on a contractual provision (clause 12.3) in BT’s standard contract for the supply of BES and/or WES services, which BT had entered into with each Disputing CP. Ofcom considered that the Disputing CPs had not provided:

“strong and compelling evidence that clause 12.3 is not fair and reasonable such that we should intervene in the light of our regulatory objectives to set it aside.”  
(Determination, para 15.144)

## VI. THE APPEALS

61. As stated above, there are three distinct appeals against the Determination before the Tribunal brought by BT, Sky/TalkTalk and the Altnets, respectively. Each of the three Notices of Appeal is a substantial document. The various grounds of appeal will be examined in detail below but, in summary, they are as follows:

- (a) BT’s appeal: BT appealed on six grounds arguing that: Ofcom misinterpreted and misapplied Condition HH3.1 and, had it applied the condition correctly, the overcharge found would have been considerably lower (Grounds 1 and 2); Ofcom’s approach violated the principles of legal certainty (Ground 3); a number of adjustments should be made to BT’s RFS that would reduce the amount of the overcharge (Ground 4); Ofcom had no power to order repayment of sums ‘paid without dispute’ by the Disputing CPs, albeit in breach of a cost orientation obligation (Ground 5); and, in the alternative to Ground 5, Ofcom incorrectly exercised its discretion by ordering full repayment (Ground 6).<sup>23</sup> It is notable that,

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<sup>23</sup> BT’s written closing submissions appeared to the Tribunal to rely on a further ground of appeal not included in its Notice of Appeal and not previously pursued before the Tribunal. This matter was raised with counsel for BT by the Tribunal at the conclusion of BT’s oral closing, on the

although it disputes the precise amount and Ofcom's power to order repayment, BT accepts that it did overcharge the Disputing CPs by tens of millions of pounds.

- (b) Sky/TalkTalk's appeal: Sky and TalkTalk contended that: Ofcom was wrong to assess compliance with Condition HH3.1 on the basis of only the DSAC cost measure and, had Ofcom applied the correct cost test, it would have found significantly higher levels of overcharging (Ground 1); Ofcom should have made a regulatory asset value ("RAV") adjustment to BT's RFS, which would also have increased the overcharge figure (Ground 2); and Ofcom was wrong not to order the payment of interest on the sums to be repaid by BT (Ground 4). A further ground of appeal raised in the Notice of Appeal (Ground 3) was abandoned following service of Ofcom's Defence.
- (c) The Altnets' appeal: The Altnets appealed on a single ground, arguing that Ofcom was wrong not to order the payment of interest on the sums to be repaid by BT. The Altnets' appeal accordingly raises the same issue as Ground 4 of Sky/TalkTalk's appeal.

**A. The Tribunal's jurisdiction under the 2003 Act**

62. The right of appeal to the Tribunal following the determination of a dispute by Ofcom is provided by sect 192(2) of the 2003 Act. Sect 192(5)(b) provides that the notice of appeal must set out the grounds of appeal, and sect 192(6) states:

"The grounds of appeal must be set out in sufficient detail to indicate—

(a) to what extent (if any) the appellant contends that the decision appealed against was based on an error of fact or was wrong in law or both; and

(b) to what extent (if any) the appellant is appealing against the exercise of a discretion by OFCOM, by the Secretary of State or by another person."

Sect 195(1)-(2) then provide as follows:

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final day of the hearing and BT subsequently applied for permission to amend its Notice of Appeal so as to introduce that additional ground. That application was refused: n. 12 above.

“(1) The Tribunal shall dispose of an appeal under section 192(2) in accordance with this section.

(2) The Tribunal shall decide the appeal on the merits and by reference to the grounds of appeal set out in the notice of appeal.”

63. It is common ground that these provisions give effect to Art 4 of the Framework Directive, which provides insofar as material:

“1. Member States shall ensure that effective mechanisms exist at national level under which any user or undertaking providing electronic communications networks and/or services who is affected by a decision of a national regulatory authority has the right of appeal against the decision to an appeal body that is independent of the parties involved. This body, which may be a court, shall have the appropriate expertise to enable it to carry out its functions effectively. Member States shall ensure that the merits of the case are duly taken into account and that there is an effective appeal mechanism.”

64. The nature of an appeal to the Tribunal against a decision of Ofcom was the subject of some dispute between the parties. It is an appeal “on the merits” (sect 195(2)) and it is clear from sect 192(6) that it can cover material errors of fact or of law, and that it can go beyond that to challenge the exercise of discretion. The question is the extent to which the Tribunal should be prepared to interfere with a determination by Ofcom. Since there have been numerous appeals to this Tribunal against various decisions by Ofcom, it is unsurprising that this has been considered in previous cases.

65. In *Telefónica UK Ltd v Ofcom* [2012] CAT 28, the Tribunal referred extensively to the observations on the nature of an appeal to the Tribunal against an Ofcom dispute determination made in the Court of Appeal in *Telefónica O2 UK Ltd v BT* (the “08 Numbers case”) [2012] EWCA Civ 1002, by Lloyd LJ (with whom Etherton and Elias LJJ agreed). The Tribunal said this (at [45]):

“We draw attention to two points in particular which emerge from this passage in the judgment of Lloyd LJ. First, the function of the Tribunal is not to act as ‘a fully equipped duplicate regulatory body waiting in the wings just for appeals’, to quote the graphic phrase used by Jacob LJ in the *T-Mobile (UK) Ltd v Ofcom* [2008] EWCA Civ 1373, and it may be very difficult for the Tribunal to interfere “if all that is impugned is an overall value judgment based upon competing commercial considerations in the context of a public policy decision” (ibid.). Secondly, and to similar effect, if Ofcom ‘has addressed the right question by reference to relevant material, any value judgment on its part, as between different relevant considerations, must carry great weight’: see the concluding words of paragraph [67]. Another way of making the same point is to say that the weight to

be attached to different considerations in forming a value judgment is a matter for Ofcom, as the NRA charged with the duty of resolving disputes, and in the absence of any misdirection by Ofcom the court will normally respect its determination, whether or not the court would itself have balanced the considerations in the same way and reached the same conclusion.”

66. Further consideration was given to the appellate role of the Tribunal in *British Sky Broadcasting Ltd and ors v Ofcom* (the “Pay TV case”) [2012] CAT 20. That case concerned a number of appeals from a decision of Ofcom under sect 316 of the 2003 Act varying a broadcasting licence but, pursuant to sect 317(7), the provisions of sects 192(3)-(8) and 195 apply to such an appeal just as they do in the case of an appeal under sect 192(2). In particular, the Tribunal considered what was meant by an “appeal on the merits” in sect 195(2), having regard not only to previous statements by this Tribunal but to observations of the higher appellate courts in other fields, in particular by Lord Hoffmann in *Home Secretary v Rehman* [2003] 1 AC 153. After holding that it was clearly entitled to decide questions of law and to correct material errors of fact, the Tribunal considered its approach to judgments by Ofcom as to whether a practice precluded “fair and effective competition” (which was the relevant test under sect 316) and whether to impose a licence condition, and said this (at [87]):

“... we consider that the following principles should inform our approach to disputed questions upon which Ofcom has exercised a judgment of the kind under discussion:

(a) Since the Tribunal is exercising a jurisdiction “on the merits”, its assessment is not limited to the classic heads of judicial review, and in particular it is not restricted to an investigation of whether Ofcom’s determination of the particular issue was what is known as *Wednesbury* unreasonable or irrational or outside the range of reasonable responses.

(b) Rather the Tribunal is called upon to consider whether, in the light of the grounds of appeal and the evidence before it, the determination was wrong. For this purpose it is not sufficient for the Tribunal simply to conclude that it would have reached a different decision had it been the designated decision-maker.

(c) In considering whether the regulator’s decision on the specific issue is wrong, the Tribunal should consider the decision carefully, and attach due weight to it, and to the reasons underlying it. This follows not least from the fact that this is an appeal from an administrative decision not a *de novo* rehearing of the matter, and from the fact that Parliament has chosen to place responsibility for making the decision on Ofcom.

(d) When considering how much weight to place upon those matters, the specific language of section 316 to which we have referred, and the duration and intensity of the investigation carried out by Ofcom as a specialist regulator, are clearly

important factors, along with the nature of the particular issue and decision, the fullness and clarity of the reasoning and the evidence given on appeal. Whether or not it is helpful to encapsulate the appropriate approach in the proposition that Ofcom enjoys a margin of appreciation on issues which entail the exercise of its judgment, the fact is that the Tribunal should apply appropriate restraint and should not interfere with Ofcom's exercise of a judgment unless satisfied that it was wrong.”

67. Perhaps because an appeal from that judgment was pending, this passage was not cited to us, but after the hearing in the present case those principles were endorsed by the Court of Appeal in its judgment on the *Pay TV* case: *BT v Ofcom* [2014] EWCA Civ 133, per Aikens LJ at [88], with whose judgment Arden and Vos LJ agreed. We consider that, *mutatis mutandis*, those principles should similarly guide our approach to the challenges to the Determination on the basis of the requirements in sect 4 of the 2003 Act and Art 8 of the Framework Directive. In particular, since, as has repeatedly been emphasised, the Tribunal is not a second-tier regulator, the fact that the Tribunal might have preferred to give different weight to various factors in the exercise of a regulatory judgment would not in itself provide a sufficient basis to set aside the determination made by Ofcom.
68. Further, the fact that this is an appeal has implications for the approach of the Tribunal to the evidence. It may be appropriate for the Tribunal to hear evidence in verification or amplification of matters and arguments placed before Ofcom in the dispute resolution process. But new evidence that brings in matters that were not placed before Ofcom at all falls into a different category. The question of new evidence on such an appeal was addressed by the Court of Appeal in *BT v Ofcom* [2011] EWCA Civ 245 (the “08 Numbers (*Preliminary Issues*) case”). That was also an appeal against a determination by Ofcom resolving a dispute. In his judgment, with which the Chancellor and Sullivan LJ agreed, Toulson LJ said this:

“60. The task of the appeal body referred to in Article 4 of the Framework Directive is to consider whether the decision of the national regulatory authority is right on “the merits of the case”. In order to be able to make that decision the Framework Directive requires that the appeal body “shall have the appropriate expertise available to it”. There is nothing in Article 4 which confines the function of the appeal body to judgment of the merits as they appeared at the time of the decision under appeal. The expression “merits of the case” is not synonymous with the merits of the decision of the national regulatory authority. The omission from Article 4 of words limiting the material which the appeal body may consider is unsurprising. When an appeal body is given responsibility for considering the merits of the case, it is not typically limited to considering the material which was

available at the moment when the decision was made. There may be powerful reasons why an appeal body should decline to admit fresh evidence which was available at the time of the original decision to the party seeking to rely on it at the appeal stage, but that is a different matter.

...

62. Section 192 of the CA 2003 came into effect one month after the introduction of the CAT rules referred to in section 192(3). Before the enactment of the CA 2003 the CAT had considered the question whether in appeals from the Director General of Fair Trading under the Competition Act 1998 the parties were limited in the introduction of new evidence. The CAT held that they were not: *Napp Pharmaceutical Holdings v The Director General of Fair Trading* [2002] CAT 1, [2002] Comp A R 13 at [134]. In that case the CAT referred to it as virtually inevitable that, at the judicial stage, certain aspects of the decision were explored in more detail than during the administrative procedure, and that it might be appropriate for the CAT to receive further evidence and hear witnesses.

63. There are differences in wording between the Competition Act 1998 and the CA 2003, but the CAT has a similar function under both Acts. The same rules apply and Parliament must be taken to have been aware of the approach taken by the CAT towards the determination of appeals from the relevant regulator.”

69. Rejecting the submission of Ofcom that new evidence should be admitted only if it satisfied the rule in *Ladd v Marshall* that applied in civil appeals, Toulson LJ continued:

“70. Under Article 4 of the Framework Directive, the appeal body is concerned not merely with Ofcom's process of determination but with the merits. Ofcom is not only an adjudicative but an investigative body, and the appellant may wish to produce material, or further material, to rebut Ofcom's conclusions from its investigation. It is unsurprising that the CAT should adopt a more permissive approach towards the reception of fresh evidence than a court hearing an appeal from a judgment following the trial of a civil action. Indeed, as Sullivan LJ observed, the appeal body might in some cases expect an appellant to produce further material to address criticisms or weaknesses identified by Ofcom.

71. Ofcom submitted in its skeleton argument that an unfettered right to adduce fresh evidence on appeal might cause parties to avoid proper engagement with Ofcom during the dispute resolution process. No party has an unfettered right to adduce fresh evidence on an appeal to the CAT, and there is force in Ms Rose's argument that parties ought to be encouraged to present their case to Ofcom as fully as the circumstances permit. That is a factor, among others, to be borne in mind by the CAT when considering the discretionary question whether to admit fresh evidence. Other relevant factors would include the potential prejudice (in costs, delay or otherwise) which other parties may suffer if an appellant is permitted to introduce material that it could reasonably have been expected to place before Ofcom. These are not necessarily the only relevant factors.

72. The court was asked by Ofcom to give clear guidance to the CAT about the exercise of its power to admit fresh evidence. Before the CAT there was argument whether it was for the party seeking to adduce fresh evidence to show why it should be given permission to do so, or was for the opposing party to show why



permission should not be granted. Since the introduction of fresh evidence is not a matter of right, in the event of a dispute about its admission I would regard it as the responsibility of the party who wants to introduce it to show a good reason why the CAT should admit it. The question for the CAT would be whether in all the circumstances it considers that it is in the interests of justice for the evidence to be admitted. I would not attempt to lay down any more precise test, nor would I attempt to lay down a comprehensive list of relevant factors or suggest how they should be balanced in a particular case. There are several reasons why I consider that it would be inappropriate, and is unnecessary, for this court to do so.”

70. In the present case, no party applied to exclude any of the evidence that was filed. As regards Ground 4 of Sky/TalkTalk’s appeal and the Altnets’ appeal, Ofcom indeed expressly accepted that it is appropriate for the Tribunal to take into account the new evidence which those parties adduced with regard to the decision about interest: Ofcom Defence, paras 545 and 551. However, in support of Ground 4 of BT’s appeal, BT submitted data and factual explanations that had not been presented to Ofcom at the administrative stage as the basis on which it argued that certain adjustments should be made to the figures for costs derived from the RFS. While not formally objecting to that new evidence, Ofcom expressed concern about BT’s ability to rely upon it. We consider below, when addressing that Ground, to what extent it is appropriate to base a decision on that new material.

**B. The evidence**

71. BT and the Disputing CPs adduced evidence from no fewer than 14 witnesses of fact. BT had six witnesses, as did the Altnets, while Sky and TalkTalk had a single witness each. All of these witnesses, save one, were called for cross-examination. Despite this, there were hardly any real factual disputes between them, save for the circumstances in which clause 12.3 (which purports to exclude the right to interest on any charge that is recalculated or adjusted with retrospective effect under a determination by Ofcom) came to be included in BT’s standard form contract for the supply of Ethernet services. That was the subject of the new evidence to which we have just referred and, as explained below, we do not consider it necessary to make any findings regarding the details of that negotiation. The cross-examination was accordingly directed more at probing the way the various companies made decisions about costs, prices, purchasing and the

reference of disputes to Ofcom. The oral evidence from some of the witnesses was very brief and, indeed, we heard all 13 of them in two and a half days. We found all these witnesses to be clearly honest in presenting their account and perspective in their evidence.

72. The Tribunal received and heard much more substantial, and divergent, expert evidence. BT called two economists, Dr Daniel Maldoom and Mr Greg Harman, and an accountant, Mr David Coulson (who had formerly been employed by BT, principally in its regulatory finance team). Sky/TalkTalk called two economists, Dr George Houpis and Mr Tom Robinson. The Altnets called an economist, Mr Derek Holt. Ofcom called only one witness, Mr Geoffrey Myers, who is Director of Competition Economics at Ofcom and also a Visiting Professor in Regulation at the London School of Economics. Mr Myers was responsible for overseeing the economic analysis in the Determination, and to that extent his evidence was in part as a witness of fact. He was also involved in the leased lines market review, which led to the 2004 LLMR, but not in the market reviews that led to the 2008 BCMR and 2009 LLCC. In addition, however, Mr Myers gave evidence also as an expert economist. It was put to him that he was appearing as the “champion of Ofcom” to defend the Determination but Mr Myers denied this and said that he was very conscious of his duty to the Tribunal. We accept that answer and do not find that the fact that he was employed by Ofcom impeded his objectivity.
73. Unsurprisingly, we found that all the experts were honest witnesses seeking to assist the Tribunal. However, we are bound to say that, on occasion, we found Dr Maldoom’s evidence to be unduly dogmatic in his support of BT, which had instructed him, and that, as a consequence, it was not always as helpful as it might otherwise have been. Furthermore, as we relate below, following his cross-examination, Sky/TalkTalk effectively disowned part of Mr Robinson’s evidence, writing, through their solicitors, to state that they no longer relied on it and putting forward certain replacement calculations from their other expert, Dr Houpis. We consider the implications of that below.

**C. Measures of Cost and Efficiencies**

74. These appeals, like the Determination, involve consideration of different measures of cost. It is, therefore, important to explain the different cost concepts that are used. The meaning of these terms is not contentious and we set out the explanations set out in the Glossary at Annex 6 to the Determination:

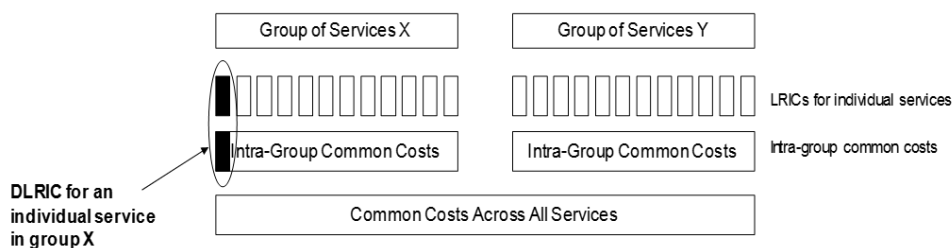
**“Incremental cost** is the cost of producing a specified additional product, service or increment of output over a specified time period.... Another way of expressing this is that the incremental costs of a service are the difference between the total costs in a situation where the service is provided and the costs in another situation where the service is not provided.

**Long Run Incremental Cost (“LRIC”)** is the incremental cost over the long run, i.e. the period over which all costs can, if necessary, be varied.

**Common costs** are those costs which arise from the provision of a group of services but which are not incremental to the provision of any individual service....

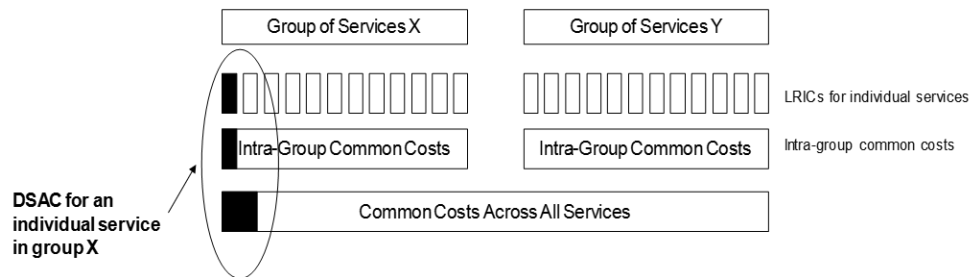
**Stand Alone Cost (“SAC”)** is the cost of providing that particular service on its own, i.e. on a stand-alone basis.

**Distributed Long Run Incremental Cost (“DLRIC”)** is a cost measure related to the LRIC of a component. Within BT’s network, groups of components are combined together to form what is known as a “broad increment”. Two of these “broad increments” are the core network (the “Core”) and the access network (“Access”). The DLRIC of a component is equal to the LRIC of a component plus a share of the costs that are common between the components within the “broad increment” (which are known as “intra-group” common costs). The common costs are shared between the components by distributing them on an equi-proportionate mark-up (EPMU) basis. The sum of the DLRICs of all the components in the Core is equal to the LRIC of the Core itself. This is represented in the diagram below:



**Distributed Stand Alone Cost (“DSAC”)** is a cost measure related to the SAC of a component. As described above, there are components within the “broad increment” of the Core. As an example the DSAC of a core component is calculated by distributing the SAC of the Core between all the components that lie within the

Core. Each core component therefore takes a share of the intra-group common costs, and the costs that are common to the provision of all services. The sum of the core components DSACs is equal to the SAC of the Core. This is represented in the diagram below:



**Fully allocated cost (“FAC”)** is an accounting approach under which all the costs of the company are distributed between its various products and services.”

75. It is also relevant to set out the three kinds of efficiencies to which economists may have regard. These, too, are not contentious and we quote from the points of agreement in the helpful experts’ joint statement (of Dr Houpis, Dr Maldoom and Mr Myers) made with reference to the assessment of the rival approaches adopted by Ofcom in the Determination and advocated by Sky/TalkTalk in their appeal:

“3.2 There are three main elements of economic efficiency that should be considered in assessing the two approaches ... :

- (i) Allocative efficiency
- (ii) Dynamic efficiency, and
- (iii) Productive efficiency

3.3 In the current context ..., short-run allocative efficiency requires that prices are set in a way that maximises the total level of demand (subject to the recovery of the costs of provision) in order to produce the greatest possible benefits to end users which in turn requires that:

- (i) the level of prices for a set of relevant services that share common costs is set no higher than necessary to generate revenues consistent with BT recovering its (efficient) costs of provision (including the appropriate level of cost of capital); ... ; and
- (ii) where prices are set for a multitude of products which share fixed and common costs, the structure of prices is set such that it maximises overall end user demand. This in general will require that relatively more fixed and common (f/c) costs are recovered from services that face demand from consumers that is relatively price insensitive (or price ‘inelastic’).

3.4 Dynamic efficiency in the current context requires that prices are set in a way that provides the appropriate incentives for:

(i) BT to undertake efficient investments in the provision of the cost oriented services in question; and to introduce new/innovative services;

(ii) downstream competition and efficient downstream investment by rivals who purchase the cost oriented services; and

(iii) efficient new entry in the provision of cost oriented services (taking into account that efficient entry in this context includes entry that may be statically inefficient in the short term but provides sufficient offsetting benefits in the longer term ... );

3.5 Productive efficiency in relation to the provision of services that are subject to cost orientation by BT requires that BT produces the cost oriented services at as low a cost as possible.”

76. Before turning to assessment of the various grounds of appeal, we should mention that on almost every ground the parties and interveners put forward, both orally and in writing, a wide range of arguments. We have taken all those arguments into account, but it would have further prolonged an already lengthy judgment if we had sought to address every single argument. We have therefore concentrated on what we consider to be the main or most significant arguments under each ground.

## **VII. CONDITION HH3.1: INTERPRETATION AND APPROACH**

77. In the Determination, Ofcom applied its test for cost orientation (the DSAC test) to BT’s charges for each of connections, rentals and main link, for each of the different BES and WES services (i.e. each different bandwidth) in each year subject to dispute. For example, Ofcom applied the DSAC test to the connection charge for a BES 10 circuit in a particular year and applied the DSAC test separately to the rental charge for a BES 10 circuit in that year. In other words, cost orientation for each individual charge in dispute was assessed separately.

78. BT contends that Ofcom misconstrued Condition HH3.1, which should not be applied at this disaggregated level. Although expressed in different ways, that contention lies at the heart of Grounds 1 and 2 of BT’s appeal. Further, BT contends that Ofcom’s application of its test contravened the principle of legal certainty, and also that the test was applied in an inappropriately mechanistic manner in finding a breach of the cost orientation obligation as regards particular services in particular years: Ground 3 of BT’s appeal.

79. Sky/TalkTalk contend, in Ground 1 of their appeal, that Ofcom’s reliance on the DSAC test alone was a fundamental error of interpretation and approach. Ofcom should have applied a further test to BT's charges based on the significantly stricter cost measure of FAC, which would have led Ofcom to find a much higher amount of overcharge.
80. Before considering these various grounds in turn, it is convenient to set out again the language of Condition HH3.1:

“Unless Ofcom directs otherwise from time to time, the Dominant Provider [BT] shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by Condition HH1 is reasonably derived from the costs of provision based on a forward looking long run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed.”

**A. BT’s Ground 1**

81. BT’s Ground 1, as originally set out in its Notice of Appeal, alleged that the proper approach to Condition HH3.1 was to determine the cost orientation of each of the two categories of service, BES and WES, considered as a whole, i.e. across all bandwidths and aggregating connections, rentals and main link. However, that contention was expressly abandoned in BT’s Reply. Its submission now is that cost orientation applies to the overall charge for a service that may be the subject of a request for Network Access under Condition HH3.1, and that Ofcom misinterpreted the condition by determining cost orientation separately as regards the charges for connection, rental and main link. Although BT’s Ground 2 appeared in the end substantially to overlap with Ground 1, the former concerns only the question of aggregation of connections and rentals, whereas the latter involves the aggregation also of main link.
82. The resulting position, whereby BT purports to give Condition HH3.1 a different meaning in its Grounds 1 and 2, arises, according to Mr Rhodri Thompson QC, appearing for BT, because Ground 1 “essentially turns on the scope of the market definition and the basis on which the condition was imposed”; whereas in the context of Ground 2, BT “advance[s] a number of economic and factual

considerations which are relevant not only to construction of HH3.1 but also to the way in which connections and rentals are treated generally.”

83. We note that BT’s contention in its Ground 1 that main link should be aggregated with connections and rentals appears to be a reversal of the position it had accepted in response to Ofcom’s Provisional Conclusions published in the course of the dispute resolution process: see the Determination at para 8.19.
84. Essentially, this ground raises a question of law concerning the correct construction of the condition and its proper application to the facts. We accept that the condition is to be construed against the surrounding circumstances (or factual matrix) at the time it was imposed, in particular the 2004 LLMR and the nature of the AISBO market at that time. BT did not suggest that the condition assumed a different meaning after it was re-imposed (for low bandwidth AISBO services only) by the 2008 BCMR.
85. This is not the first occasion when the Tribunal has been called upon to consider the interpretation of a cost orientation obligation expressed in these terms. As we have already mentioned, the 2004 LLMR identified for TISBO products distinct markets for: (a) TISBO with a bandwidth up to and including 8 Mbit/s; (b) TISBO with a bandwidth above 8 Mbit/s and up to 155 Mbit/s; and (c) wholesale trunk segments at all bandwidths. Of these, (a) and (b) comprise terminating segments whereas (c), self-evidently, comprises trunk segments. A PPC is made up of either trunk and terminating segments, or terminating segments alone. BT was found to have SMP in all three of these markets in the UK (excluding, for terminating segments, the Hull area) and was made subject to cost orientation obligations in respect of each of those markets by the 2004 LLMR. The relevant obligations were Condition G3.1 for terminating segments and Condition H3.1 for trunk segments.
86. Various CPs (including the three Altnets that are appellants in the present case) submitted disputes to Ofcom contending that BT was overcharging for PPCs in breach of its cost orientation obligations. On 14 October 2009, Ofcom issued its determination of those disputes (“the *PPC* determination”), finding that BT had

overcharged by over £41 million in respect of 2 Mbit/s trunk services in the period 1 April 2005 to 30 September 2008, and directed repayment. Ofcom rejected the complaints in respect of the period before 1 April 2005 and as regards terminating services. BT appealed to the Tribunal, which dismissed the appeal: [2011] CAT 5 (“the *PPC* CAT judgment”).<sup>24</sup> A further appeal to the Court of Appeal on more limited grounds was also dismissed: [2012] EWCA Civ 1051 (“the *PPC* CA judgment”).

87. The cost orientation obligation in Condition H3.1, which BT was found to have breached, was identical in wording to condition HH3.1 at issue in the present case. Among the issues in the *PPC* case was the correct construction and application of Condition H3.1. In the *PPC* CAT judgment, the Tribunal noted that an SMP condition, imposed by Ofcom under the 2003 Act pursuant to its statutory duties, is a public law instrument. Addressing the proper approach to interpretation, the Tribunal said this:

“202. Whereas in the case of a contract, the relevant factual matrix will extend to what was reasonably available to the contracting parties, in the case of a public law instrument, which (as in the case of an SMP condition) is promulgated to the world at large, the relevant factual material will only extend to the material reasonably available to the public at large (and so will typically be narrower than the relevant factual matrix in a contractual context).

203. In the present case, we consider the relevant factual matrix to be quite limited, and to be confined to the relevant statutory framework for the imposition of SMP conditions (specifically, the 2003 Act and the EU directives comprising the common regulatory framework) and to the published documents that led up to the SMP conditions imposed in this case (including, in particular, the 2004 LLMR Statement).

204. Clearly, documents post-dating the imposition of the SMP conditions in this case cannot form part of the factual matrix, being after the event. As regards documents in the more distant past – like for instance – Oftel’s “Guidelines on the Operation of the Network Charge Controls”, published in 1997 and 2001 – we recognise that they contribute to an understanding of how the regulatory controls and related concepts evolved. However, in terms of construction of the SMP conditions, they are of mainly historical interest, and tend to be of marginal, if any, assistance.”

88. None of the parties to the present appeals sought to challenge this approach, save only that some made reference to the Oftel Guidelines or sought to place some

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<sup>24</sup> Certain issues raised by BT’s appeal were heard initially as preliminary issues, addressed in a separate judgment: [2010] CAT 15 (“the *PPC* (*preliminary issues*) judgment”): see further para 265 below.



reliance on public documents issued after 2004. We respectfully adopt the approach set out in the *PPC CAT* judgment as correct.

89. The starting point for interpretation is the language of the condition itself: see at para 80 above. This requires cost orientation of “each and every charge offered, payable or proposed for Network Access covered by Condition HH1...” On its face, this means that if BT charges separately for different elements in a service, then *each and every one* of those charges has to be cost oriented. That the provision of network access in response to a request may involve several charges is clearly envisaged by Condition HH1.2, which provides that the provision of Network Access in accordance with Condition HH1 shall be “on fair and reasonable terms, conditions and *charges*” (our emphasis).
90. This is indeed the position on the facts. BT’s charges for connection, rental and main link are not only quoted separately in its OPL but they are itemised separately in its billing. They relate to aspects that are conceptually distinct, albeit that there are various ways in which the overall or common costs of a particular BES or WES service could be allocated to one or the other. We further note that separate charges were levied by BT for connections and rentals from at least March 2003, i.e. well before the 2004 LLMR. Accordingly, the cost orientation obligation should apply to each of those charges and not to them in aggregate.
91. This interpretation of Condition HH3.1 according to its ordinary meaning is reinforced by the fact that the rental charge for each WES and BES service levied by BT was uniform: i.e., in determining the amount payable by a CP to BT in rental charges for a circuit, it was irrelevant whether it was the first, second or, indeed, a subsequent year of the contract.<sup>25</sup> By contrast, the connection charge was payable, as its name makes clear, only at the time of connection of a circuit, i.e. at the outset; thereafter, the only charge *payable* by the CP for Network Access was the rental charge. Thus, applying the wording of the condition to the charge payable by a CP in the second or third year of a BES/WES service, we do not see how the language permits the aggregation of that rental charge with a connection charge that is not payable in that year at all.

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<sup>25</sup> Albeit that the actual amount might vary from time to time according what was stated in the OPL.

92. Moreover, although most CPs seeking a particular WES or BES service from BT had to pay, in the first year, both a connection and rental charge, and the charges could therefore be regarded as complements, that was not always the case. Where a CP had a LES service and migrated to WES, or if it upgraded its service to a faster speed, it was subject to a charge for that change, but in either case it was much less than the connection charge that BT seeks to aggregate with the rental charge to determine cost orientation (see para 20(a) above). Furthermore, a main link is only necessary where a circuit (WES or BES) passes through more than one BT local exchange (see para 16 above). Therefore, in many cases, a main link will not be required by the CP at all.
93. BT submitted that if it had, instead, imposed a single, overall charge for each bandwidth of service, only that charge would have had to be cost oriented. But leaving aside any question of whether CPs might have sought to challenge such an approach with Ofcom on the basis that this was not fair and reasonable as required by Condition HH1.2, the fact is that BT did not charge on that basis at any time during the period covered by the disputes, no doubt for good commercial reasons.<sup>26</sup> We consider that the cost orientation obligation should be applied to the circumstances that in fact existed and not on the basis of purely hypothetical circumstances.
94. Contrary to the supplementary submissions of BT, we do not see that the Supreme Court's recent judgment in the *08x Numbers* case, *BT v Telefónica O2 UK Ltd* [2014] UKSC 42, has any bearing on this issue. This issue concerns the interpretation and application of Condition HH3.1 imposed by Ofcom as an SMP obligation; it does not concern the application of any term in BT's contracts with the Disputing CPs.
95. We were also unimpressed by BT's submission that since Ofcom's determination of SMP was in respect of the wholesale AISBO market, any SMP obligation imposed in consequence must be applied to the products comprising that market as a whole and cannot properly apply on a more disaggregated basis. That argument

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<sup>26</sup> We note that one of BT's experts, Mr Harman, accepted in cross-examination that there was a strong incentive on BT not to combine its charges.

confuses the process of market definition with the determination of an appropriate and proportionate remedy to address the potential effect of SMP in an identified market: see in that regard Art 8(4) of the Access Directive. Moreover, Art 13(1) of the Access Directive, addressing the potential imposition of cost orientation obligations, expressly refers to “obligations for cost orientation of prices ... for the provision of *specific types of interconnection and/or access* ...” Similarly, sect 87(1) of the 2003 Act provides that where Ofcom has determined that a person has SMP “in an identified services market”, it shall set such SMP conditions as it “consider[s] ... appropriate ... in respect of the relevant network or relevant facilities”. And sect 87(9)(b) authorises Ofcom to impose cost orientation obligations “in relation to ... matters [connected with the provision of network access to the relevant network, or with the availability of relevant facilities].” The statutory discretion given to the regulator as to the scope of the remedy is broad: it can be tailored by Ofcom to the particular circumstances then prevailing, or anticipated, on the relevant market.

96. Furthermore, BT’s argument, if correct, would produce an absurdity since the market in which BT was found to have SMP in the 2004 LLMR was that for wholesale AISBO services at all bandwidths. Ofcom did not find that WES and BES services each constituted a separate market. Accordingly, if cost orientation could be determined only at the level of aggregation that corresponded to the market on which SMP was found to exist, the costs and revenues of all WES and BES services, at all bandwidths, would have to be aggregated. BT never suggested that that is the proper approach. Indeed, following service of Ofcom’s Defence, BT abandoned its initial submission that there should be aggregation across all BES bandwidths and then, separately, WES bandwidths. It is elementary that an economic market can contain a number of products or services, which may change over time.
97. We should add that we do not regard the determination of the Energis dispute (as to which, see para 48 above) as relevant. The cost orientation obligation imposed in that determination is worded differently from Condition HH3.1: it requires “[t]he charge for the network access products”, identified as the wholesale variants of specified LES services, to be cost oriented. We do not see how that difference

in wording can support a construction of Condition HH3.1 that seeks to make it correspond to the obligation imposed on BT in that distinct determination. That would amount, in effect, to re-writing Condition HH3.1 so that it required cost orientation of “the charge offered, proposed or payable for each Network Access service [or product].” Furthermore, the Energis determination was issued on 9 September 2004 and cannot constitute a surrounding circumstance of Condition HH3.1 that was imposed over two months earlier.

98. We reach our conclusion on the proper meaning and application of Condition HH3.1 on the basis set out above, without the need to rely on the statutory definition of “Network Access”. However, that definition supports the view we have reached. The definition and interpretation provision accompanying Conditions HH, states:

“... except insofar as the context otherwise requires, words or expressions shall have the meaning assigned to them and otherwise any word or expression shall have the same meaning as it has in the [2003] Act.”

99. Sect 151 of the 2003 Act provides, insofar as material:

“(3) In this Chapter references to network access are references to—

...

(b) any services, facilities or arrangements which—

(i) are not comprised in interconnection; but

(ii) are services, facilities or arrangements by means of which a [communications provider or]<sup>27</sup> person making available associated facilities is able, for the purposes of the provision of an electronic communications service (whether by him or by another), to make use of anything mentioned in subsection (4);

and references to providing network access include references to providing any such services, making available any such facilities or entering into any such arrangements.

(4) The things referred to in subsection 3(b) are—

(a) any electronic communications network or electronic communications service provided by another communications provider;

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<sup>27</sup> The words in parenthesis were deleted by the 2011 Regulations but this makes no material difference to the point at issue here.

(b) any apparatus comprised in such a network or used for the purposes of such a network or service; ...”

100. Accordingly, “Network Access”, as used in the 2004 LLMR, includes any services, facilities or arrangements “*by means of which*” a person is able to make use of: “*any electronic communications network or electronic communications service*” provided by another CP, and “*any apparatus*” comprised in such a network or used for the purposes of such a network. This is a very broad definition, which encompasses a number of things. We accept the submission of Ofcom that the connection, rental and, indeed, main link offered or provided for each BES and WES circuit constitute discrete facilities or arrangements by means of which the Disputing CPs could make use of those individual services or networks, or alternatively apparatus used for the purpose of such services or networks. As such, the separate connection charge for a particular WES circuit, for example, appearing in the OPL constitutes a “charge offered, payable or proposed for Network Access covered by Condition HH1”, within the meaning of Condition HH3.1.

101. In conclusion, therefore, we reject BT’s contention that Condition HH3.1 is to be construed as requiring cost orientation of BT’s charges for connection, rental and main link of each service in aggregate and precluding assessment of the cost orientation of those charges individually.

**B. BT’s Ground 2**

102. The scope of BT’s second ground of appeal appeared to undergo some variation in the course of the proceedings. In the Notice of Appeal, this ground was advanced as an alternative to Ground 1: i.e. on the assumption that, as a matter of construction, Condition HH3.1 could apply, as Ofcom had applied it, to the charges for connection, rental and main link considered individually. BT contended that Ofcom nonetheless made “a fundamental error of analysis” in determining BT’s compliance with its cost orientation obligation by disaggregating the charges for connection and rental: paras 117-118 of BT’s Notice of Appeal. However, BT’s skeleton argument for the hearing expressed Ground 2 as an argument of construction, to the effect that Condition HH3.1 must be construed in

an economically rational way, and that Ofcom's construction did not reflect economic or commercial reality. BT contended that Ofcom had failed to take into account the economic characteristics of the charges for connections and rentals, which form part of the factual matrix for construing the Condition and for determining its correct application. The Skeleton stated: "The argument on construction in Ground 2 is additional to the argument in Ground 1" (para 59, fn.56).

103. There are problems with either approach. If Ground 2 is an alternative to Ground 1, then it means that Condition HH3.1 should, on economic grounds, be applied contrary to its proper construction (as determined in addressing Ground 1). We do not see how that can be right. BT advanced a similar proposition in the *PPC* case. There, BT argued that terminating charges and trunk charges should be aggregated although those elements constituted different markets. Having rejected that contention as contrary to the clear meaning of the cost orientation condition, the Tribunal then dismissed BT's submission that the cost orientation should be assessed on the basis of the combined charge since a disaggregated approach was inconsistent with a proper economic approach to cost orientation. The Tribunal stated (at [229(2)]):

"Having concluded that the meaning of [the SMP] conditions is clear, we fail to see how either OFCOM or this Tribunal could sanction an approach that disregarded the clear meaning of Condition H3.1"

The Tribunal proceeded to remark that if BT disagreed with the effect of the condition imposed, then it could, and should, have appealed the initial decision to impose it, i.e. it should have appealed against at least aspects of the 2004 LLMR itself. We respectfully agree with, and adopt, those observations.

104. If, on the other hand, Ground 2 is ancillary to Ground 1, then it relies on economic arguments in support of a construction of the Condition that is inconsistent with the construction advanced under Ground 1. As indicated above, Ground 1 argues that connection, rental and main link charges should be assessed in aggregate, whereas the economic arguments advanced under Ground 2 support only the aggregation of connection and rental charges.

105. We shall proceed nonetheless to consider Ground 2 on the basis that, as we understood it, featured prominently in the way BT put its case: i.e. that economic and commercial reality compelled a construction of Condition HH3.1 pursuant to which the charges for connection and rental of an individual WES or BES product are to be assessed together.
106. We can accept that, in principle, a construction of an SMP condition that was contrary to commercial and/or economic reality may be unjustified, especially as the condition is imposed to remedy an anti-competitive distortion of the market that may result from SMP. However, we find that the various arguments advanced by BT do not support such a conclusion in this case.
107. BT submitted that connection and rental charges should be aggregated because there was no one ‘correct’ way to allocate the common costs of the service as between them. BT’s expert, Mr Harman, gave evidence that, from an accounting perspective, it would be reasonable to allocate the capital costs of equipment, and in particular of the electronics, either to connection or to rental. Since the electronics, which BT allocated to connections in its RFS until 2010/11, accounted for over 90% of the connection costs, that choice made a significant difference to the respective DSACs of connections and rentals. Mr Harman calculated that the extent of the overcharge, although still very significant, would be appreciably less if the allocation of electronics were changed. The alleged arbitrariness of that result would, BT argued, be avoided by the aggregation of the charges for, and costs of, these two elements.<sup>28</sup>
108. However, this case concerns an *ex ante* SMP condition, where BT was required to set its prices on a cost-oriented basis. BT was given the freedom to determine the allocation of the capital costs of the service as between the constituent elements of the service – and indeed changed its view on the allocation of electronics in the 2010/11 year when it decided to allocate those costs to rentals having previously allocated them to connections. BT set out what it had done in its published RFS, on which Ofcom and also other CPs relied. Ofcom has not sought to change BT’s

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<sup>28</sup> Mr Harman found that combining connection with rental would reduce the overcharge from £94.8 million to £82.1 million. He did not consider the treatment of main link.

allocation in order to compute the DSACs. On the contrary, Ofcom has simply adopted BT's own allocation, which BT evidently considered was reasonable at the time. Mr Dolling, the Director of BT's Group Regulatory Finance Department and himself a chartered accountant, gave evidence that BT chooses the method of attribution that it regards as the most appropriate. In response to a question challenging his view that there was one correct answer, Mr Dolling responded:

“...we actually take great care in actually selecting the appropriate attribution methodology. So by definition in the end the one that we choose at that particular time was the one that we feel is the most fair and agrees with the principles of, as I have said, cost causality and objectiveness.”

Mr Harman acknowledged that BT's allocation of costs as between connections and rentals was reasonable: his evidence, which in this respect expressed a rather different view from that of Mr Dolling, was that there was an equally reasonable alternative. However, on either approach, there were no grounds for Ofcom to apply an allocation of costs different from that which BT had itself decided upon at the time and set out in its RFS.

109. Moreover, Mr Harman agreed that a change to BT's decision as to the allocation of capital costs as between connection and rental could have virtually the same effect as regards overcharging as taking an overall DSAC of connection and rental combined. Mr Harman indeed said that it is undesirable if there is “too much interference” by a regulator in the way in which a company like BT does its allocation of costs as between the different items. However, since Condition HH3.1 allows BT to allocate its costs in whatever way is reasonable and gives it flexibility in that regard, this is not a basis for construction of the condition as requiring the aggregation of charges so as to measure them against an aggregated DSAC.
110. BT's economic expert, Dr Maldoom, stressed the uncertainty of cost estimates and repeatedly emphasised that the more costs have to be disaggregated, the greater the degree of uncertainty and potential for error. That is no doubt the case. But both Dr Maldoom and Mr Harman agreed that DSAC is not a normal accounting concept used by businesses in commercial decisions as to price. Mr Harman said that he had not encountered DSAC in all his years as an accountant until he



entered the field of telecommunications regulation. He agreed that if a multi-product firm launched a new service, it would need to price that service so as to recover its marginal cost plus a reasonable rate of return – what economists would refer to as LRIC (or LRIC plus a reasonable rate of return insofar as that is not included in LRIC). If those responsible for pricing the service were instructed that it should also contribute to the overall fixed or common costs of the firm, then they would need to use a measure which apportioned those costs. Mr Harman explained that the most usual measure would be FAC, which is a well established concept, although there are alternative methods, for example according to the number of employees devoted to different parts of the business.

111. Condition HH3.1 did not specify that BT should price at DSAC or apply DSAC as the target of its pricing: it does not refer to DSAC at all. BT could have complied with the cost orientation obligation by pricing at its best estimate of FAC and, indeed, could have priced above FAC. DSAC is only relevant because, BT having failed to demonstrate to Ofcom’s satisfaction that it had complied with Condition HH3.1, Ofcom was called on to determine compliance itself and applied DSAC as the outer bound of the prices that BT could charge: i.e. on the basis that prices above DSAC would not usually be cost oriented.<sup>29</sup> The economic experts agreed that the DSAC of a service is, typically, significantly higher than its FAC. Therefore, the DSAC test applied by Ofcom gave BT what Dr Maldoom described as “a margin for cost uncertainty” or “a buffer against measurement errors.” Accordingly, even if determining costs *ex ante* for rentals and connections separately was not straightforward, and was subject to errors in measurement, uncertain prediction as to volumes, and so forth, the benchmark of DSAC used by Ofcom in the Determination to assess whether BT had complied with the condition was generous to BT and gave it allowance for such errors.
112. BT indeed did not in practice set its charges by reference to DSAC: it did not know the DSAC for these services in any financial year until about July of the following year when its RFS were finalised (as to which, see para 47 above), and

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<sup>29</sup> Ofcom’s approach was that a price above DSAC would constitute a prima facie breach of Condition HH3.1 but it was, at least in principle, open to BT to explain why a charge above DSAC was nevertheless cost orientated (see Determination, paras 9.156 and 9.226, Step 3 of the approach outlined at para 9.244, and e.g, paras 14.230-14.237).

the RFS were sometimes not published until September. The RFS refer to DSAC as the “unaudited LRIC ceiling”, which language rather emphasises the point that DSAC is to be used as just that: a (generous) pricing ceiling, and not a pricing target. Thus, interpreting the condition by requiring the charges for connection and rental separately to be cost oriented does not have the consequence that it is commercially oppressive or unreasonable for BT.

113. Dr Maldoom considered that, in reality, connection and rental are part and parcel of a single charge so that it is inappropriate to consider them independently. He contended that in making purchase decisions, CPs evaluate charges in aggregate over the whole life of the service in question. As he put it in his oral evidence: “I guess my question is, on balance, what do CPs see, and what do they react to; and I believe on a general approach they look at the whole life cost [of a circuit] first because [connections and rentals] are consumed together and they are in the same market.” Mr Harman similarly expressed the opinion, as an accountant, that when a CP is considering the implementation of a new circuit, it does a net present value (“NPV”) calculation of the impending cash outflows associated with a potential purchase from BT. That calculation contains the up-front connection charge and the periodic rental charge. Therefore, BT submitted, in making decisions about whether to purchase Ethernet services or alternatively arrange to build their own services, CPs consider the combined connection and rental charge over the expected life of the service, so-called 'whole-life costing', not the individual (annual) elements of that overall charge.

114. This theoretical reasoning by BT’s experts falls down against the factual evidence given to the Tribunal, which we accept, as to how CPs actually take their decisions. Mr Vito Morawetz, the Director of Interconnect at Virgin, explained how the balance between connection and rental affects decision-making at Virgin, which predominantly sells direct to end-users and has its own extensive nationwide network of Ethernet circuits:

“Generally speaking, I describe an NPV calculation that we make in respect of a decision, for example, between self-provision and purchasing services from BT. If we self-provide the great majority of our outlay would be upfront. We will need to dig the streets, we have to buy equipment, we need [to] do a quite a lot of work on the customer side [site?] and the great majority of those costs will be upfront. The

ongoing costs will be relatively small. So it will be a very front-loaded cost of delivery on a self-provision basis.

The relative level of connection and rental influences that decision because if the BT connection charge is very high, from a cash flow perspective, we will be in an equivalent position to self-provision more rapidly, and therefore we may decide to self-provide even for [a] contract for a relatively short term. However, if the connection was low, if the rental was fairly balanced we probably would be in that position [i.e. to self-provide] only when we are assured of a relatively long tenure of the customer.”

115. Mr Andrew Parker, the Head of Carrier Supplier Management at CWW, gave evidence to similar effect as to how the balance between BT’s connection and rental charges would affect CWW’s decision to build Ethernet services themselves as against purchasing them from BT.
116. Further, Mr Morawetz explained that contracts with customers are generally for a fixed minimum term but then continue on a rolling basis, unless terminated on notice. At expiration of the initial term, however, customers may seek to negotiate a new fixed term, and such contracts are typically subject to competitive tendering, for which Virgin’s competitors include BT Wholesale, CWW and TalkTalk. In that context, the distinction between BT’s connection and rental charges is again significant:

“...We know that our cost to continue to provide the service is only the rental, and we know that the cost for potential competitors to provide the service instead of Virgin Media will be rental and connection. That gives us information of what the competitive market price should be that would enable us to retain their custom in a situation in which that service is put out to tender again. So again, we look at the rental as our ongoing cost of providing the service, but we look also at the connection because that gives us an indication of what do we need to do at the pricing level in order to retain that service.”

117. Moreover, Ofcom found that each of the Disputing CPs purchased connection and rental from BT in very different proportions, both within each of the years in question and as between years.<sup>30</sup> The significance of the data presented by Ofcom was challenged by BT, on the basis that it aggregated all Ethernet services, and Mr Coulson presented an analysis indicating that the average length of contracts for any particular service did not vary appreciably as between CPs. However, BT recognised that in any particular year, “a CP that is expanding its business will in

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<sup>30</sup> Determination, Figures 8.2-8.6. The detailed information there set out is confidential.

general buy more new circuits and will therefore incur relatively higher connection costs than a CP that has a stable business model.” Moreover, as Mr Myers of Ofcom pointed out in his witness statement:

“...not all circuits relevant to the Disputes attracted a connection charge (as some were migrated from retail circuits to WES/BES products), and circuit bandwidth downgrades and upgrades give rise to a mismatch of connection and rental charges between bandwidths.”

Thus, if BT were permitted to charge above DSAC for rental and below DSAC for connections, that would cause distortions as between CPs since some CPs would, in effect, be subsidising others.

118. The initial connection and the ongoing rental are manifestly distinct services even when they are purchased together (albeit that some costs can reasonably be allocated to either). As Mr Jones of BT confirmed in his oral evidence, the connection concerns the initial installation of the equipment, whereas the rental relates to the use of capacity over a particular piece of fibre or copper wire for a period of time. That, of course, is why customers migrating from LES to WES were charged only a nominal fee reflecting the cost of certain administrative work for BT, not for connection since they did not require new equipment.
119. In short, it is clear to us on the evidence that a distinction between the charges for connection and rental is meaningful in economic and commercial terms, and there is no basis to depart from the ordinary meaning of Condition HH3.1.

**C. BT’s Ground 3**

120. Ground 3 of BT’s Notice of Appeal encompasses three distinct but related grounds, namely that:
  - (a) Ofcom’s approach to the application of Condition HH3.1 conflicts with the principle of legal certainty since Ofcom had not specified or indicated to BT in advance how the condition would be applied, and had allegedly made statements inconsistent with the approach it adopted in the Determination;

- (b) there is a particular problem with Ofcom’s assessment of cost orientation separately for connections and rentals in 2006/07; and
  - (c) the obligation of cost orientation was applied in a rigid and mechanistic way, in particular by failing to aggregate connections and rentals, and by looking at each year in isolation and not considering the average across years. In that respect, BT complains about the findings of non-compliance in five particular instances.
121. Although (b) and (c) are put forward as “illustrations” of the more general complaint in (a), they also need to be considered separately as specific instances where Ofcom is alleged to have been wrong to find that the cost orientation obligation was breached.
- (a) *Legal certainty*
122. BT asserts that Ofcom never made clear during the period covered by the disputes how cost orientation would be assessed. In that regard, it points to the references to transparency and proportionality in various provisions of the CRF and the 2003 Act.
123. However, there is an irony in BT’s challenge on the basis of lack of certainty. BT does not make any submissions as to how it sought to comply with Condition HH3.1, nor does it advance any case that its charges *were* cost oriented. Indeed, it accepts for the purpose of its appeal that, even if its arguments on the construction of Condition HH3.1 are correct, its charges were not cost oriented. Nor does it challenge Ofcom’s use of DSAC as a benchmark for assessment. On BT’s own case, it accepts that it overcharged for its WES and BES services by a substantial amount. BT’s basic complaint is rather that the total overcharge was calculated at too high a figure because of the various alleged errors of approach by Ofcom.
124. BT’s first challenge for lack of certainty is that Ofcom failed to make clear a requirement that connections and rentals must separately be cost oriented. BT

contends that the consequence is that “Ofcom is now precluded from assessing cost orientation of rentals and connections separately”: Notice of Appeal, para 168.

125. We reject that submission for the reasons we have set out with reference to BT’s Ground 1: we consider that Condition HH3.1 is clear on its face in this respect. BT should, therefore, have understood when setting separate charges for connections and rentals, as it had done for some time even before Condition HH3.1 was imposed, that it was under an obligation to ensure (and be able to demonstrate) that each of those charges was cost oriented. Indeed, we note that BT reported the DSACs (or the ‘unaudited LRIC ceilings’, as they were referred to in its RFS) separately for connections and rentals at each bandwidth from the 2006/07 financial year onwards. There was no lack of transparency or violation of the principle of legal certainty in the approach that Ofcom adopted.
126. BT then refers to passages in a series of statements made at various times by Ofcom. However, BT notably does not suggest that Ofcom’s approach in the Determination breached any legitimate expectation on BT’s part, on which it relied in setting its charges. Condition HH3.1 did not provide that Ofcom was to monitor and evaluate BT’s charges: rather, the primary obligation, and burden of proof, was on BT to secure and be able to demonstrate, to Ofcom’s satisfaction, that its charges were cost oriented. The Condition, therefore, afforded considerable leeway to BT as to how it complied with that obligation, and only if it failed to discharge that burden would Ofcom then itself determine whether BT had complied.
127. If BT had adduced positive evidence that it set its charges in a way that it believed, based on various statements by Ofcom, ensured that they were cost oriented in accordance with Condition HH3.1, then those statements would have to be examined carefully in context, to see if they reasonably supported BT’s understanding. However, BT does not suggest in its evidence that it relied, in setting the disputed charges, on any of the various statements and documents to which it refers under Ground 3. Some of those documents were, in any event, issued relatively late in the period covered by the disputes.

128. Insofar as BT set its charges by reference to the obligation in Condition HH3.1 at all, a subject to which we return, from the evidence of Mr Coulson (who was called as an expert by BT but was, at the relevant time, Head of Group Costing and then Head of Regulatory Finance at BT) it appears that BT did so on a “portfolio” basis, considering all the costs of, respectively, BES services in aggregate and WES services in aggregate. But that approach is not pursued by BT on this appeal, save only as regards 2006/07. For the rest of the relevant period, BT accepts that this could not constitute compliance with Condition HH3.1.
129. In our judgment, the fact that Ofcom in 2004 or indeed in 2009 may have held and expressed varying views as to how cost orientation should be applied is, therefore, irrelevant. BT did not appeal the imposition of Condition HH3.1 by the 2004 LLMR, as it could have done, on the basis that it was inherently uncertain or too vague for BT to ascertain how it should comply. Nor have we seen any evidence to suggest that, short of appealing, BT engaged in discussions with, or sought any guidance from, Ofcom to ensure that it understood what was expected of it in order to demonstrate compliance, as might have been expected if BT was of the view that the Condition was inherently ambiguous or uncertain. The relevant question is whether Ofcom applied the Condition correctly in the Determination. We accept that that question is raised by heads (b) and (c) of Ground 3, which we consider below. But that is distinct from a question of legal certainty.
130. Therefore, in our view, it is unnecessary to address the various Ofcom statements and documents referred to by BT in its pleadings, and the yet further documents referred to in its skeleton argument. We comment only on BT’s reference in this regard to the 2004 LLMR. Since Condition HH3.1 was imposed pursuant to the 2004 LLMR, that document is clearly of particular relevance.
131. BT submits that the 2004 LLMR indicated that the SMP conditions were being imposed “at the level of the AISBO market viewed as a whole”: Notice of Appeal, para 171. However, Condition HH3.1 is clearly not framed in those terms. BT now accepts, with reference to its Ground 1, that the obligation is not to be interpreted as requiring cost orientation at such a high level of generality. Furthermore, we have already rejected, also in the context of Ground 1, as wrong

in principle BT's submission that an SMP obligation cannot be imposed in respect of a good or service defined in a manner that is narrower than the market in which the operator has been found to have SMP. This reference does not, therefore, assist BT's case.

(b) 2006/07

132. 2006/07 was the first year for which Ofcom found that BT overcharged. BT submits that "there were a number of specific and exceptional factors that are relevant, both individually and cumulatively, to the assessment of BT's pricing in 2006/07...": Notice of Appeal, para 221. BT contends that the Determination regarding charges in that year is flawed for failing to take those into account.
133. BT relies on the fact that, in imposing requirements for cost accounting prior to that year, Ofcom had not asked BT to report information at the disaggregated level of connections and rentals, or by separate bandwidths. For 2004/05 (the first year to which Condition HH3.1 applied), the reporting required was for Ethernet services as a whole and for 2005/06 it was for information of, respectively, the aggregated WES products and the aggregated BES products. The RFS for 2006/07, which did show disaggregation of connections and rentals by bandwidths, was produced after the end of BT's financial year.
134. However, the specifications for the RFS were prescribed subsequent to the imposition of Condition HH3.1, in order to supplement and assist the monitoring of cost orientation. Those specifications, which were repeatedly revised over the period covered by the disputes, cannot alter the meaning of Condition HH3.1, which we have found to be clear. As we have observed, BT does not allege that those requirements constituted representations relied on at that time so as to give rise to a legitimate expectation. Indeed, Mr Jones, who was responsible for setting BT's Ethernet prices, said he did not generally use the RFS in setting prices since they were produced several months after the end of the relevant year; he relied instead on BT's management accounts. Since the development in the degree of information which BT had to provide under its cost accounting obligation does not affect the proper interpretation of Condition HH3.1, it does not, in our view, alter the nature of the charges that were subject to cost orientation.



135. In its Reply, BT stated expressly that it:

“accepts that Condition HH3.1 applies to charges offered, payable and proposed in respect of reasonable requests for “Network Access” in the form of the supply of wholesale AISBO services ... and that such requests are in practice made for WES or BES services at the level of individual bandwidths.”

BT at the same time sought to argue that, by reason of lack of certainty and predictability, in the year 2006/07, exceptionally, aggregation of charges across all bandwidths of BES services on the one hand and WES services on the other hand, was permissible. However, in the absence of reliance by BT at the time on an express or implied representation by Ofcom, we do not see any basis for applying anything other than the proper interpretation of the condition.

136. BT further relies on the following factors, in summary:

- (i) the AISBO market was nascent, which led to “some degree of forecasting risk.” Calculation of demand on a prospective basis was, therefore, problematic;
- (ii) BT Openreach had only just been created, so it took time to assess the products inherited from other parts of the business and determine the appropriate pricing; and
- (iii) BT had no DSAC figures in that year and the DSACs calculated by Ofcom are “unusually low” compared to the FACs; and for BES 100 and BES 1000 rentals, the DSACs were actually below the FACs.

137. Contrary to BT’s submission, however, these factors were taken into account by Ofcom in the Determination. Ofcom accepted that the wholesale AISBO market was nascent, although the wholesale products were based on services previously sold at the retail level, and that there was significant growth in demand. Accordingly, there was uncertainty on both the supply and demand sides which led to a degree of forecasting risk: Determination, para 14.55. The creation of Openreach no doubt increased the burdens on BT. BT could have approached Ofcom at the time for a direction for relief from the obligation on that basis,

pursuant to the proviso set out in Condition HH3.1, but it did not do so. Moreover, in the dispute resolution process, it was open to BT to provide evidence to Ofcom that, on the information it had in 2006/07, it reasonably expected its charges to be cost oriented. This was made clear by Ofcom in its provisional conclusions, which explained the evidence required from BT in that regard: Determination, para 14.61.

138. It is notable that BT's charges that year were very substantially above both DSAC and FAC for each of the services for which Ofcom found an overcharge: see Table 14.5 in the Determination. Ofcom summarised its conclusion at para 14.65 of the Determination as follows:

“14.65 In our view, BT has failed to provide in its response the evidence we explained in the Provisional Conclusions would be required to support its arguments in relation to 2006/07. For example, BT has not:

14.65.1 demonstrated that its unit DSACs were lower than it reasonably expected when setting charges for 2006/07;

14.65.2 provided us with details of the volume forecasts it used in setting charges for 2006/07, together with an explanation of why it considered these to be reasonable forecasts and why the deviation from forecast led to the failure of the DSAC test; and/or

14.65.3 explained (where relevant) why any cost movements that contributed to the failure of the DSAC test could not have been reasonably forecast and provided evidence of its original cost forecast, together with the supporting reasoning for that forecast at the time.”

139. We did not see anything in the copious evidence adduced by BT on its appeal that called that conclusion into question.
140. As to the complaint regarding the low DSAC figures used by Ofcom for 2006/07, Ofcom expressly addressed that point in the Determination: see paras 12.46-12.47. Ofcom there explained that a low DSAC compared to FAC is not a reason to depart from the use of DSAC as a benchmark since the DSAC:DLRIC (i.e. ceiling:floor) ratio is more relevant. We accept that explanation, which was not challenged in the cross-examination of Mr Myers. As Table 12.10 in the Determination shows, the DSAC was well above the DLRIC – the floor – for all the services in 2006/07.

141. BT also relies on the fact that DSACs for several services in 2006/07 were unusually close to FAC in support of its contention that the DSAC figures were much lower than might have been expected. However, that is to apply hindsight. BT has not produced any evidence to show that it attempted, at the time, to forecast the DSACs (even though it accepts, at least for the purposes of this appeal, that DSAC is the correct cost standard by which to assess compliance) and did not know either the DSAC or FAC figures when it set its prices.
142. We should add that, in its Notice of Appeal, BT also relied in this context on Ofcom's handling of a complaint made in May 2007 by THUS plc., and in particular the communications that took place in June-July 2007 between Ofcom's accountants and staff from BT's regulatory affairs department, as set out in the evidence of Ms Karen Wray. However, on 10 July 2007, Ofcom emailed Ms Wray informing her that Ofcom had decided not to open an investigation into the complaint on the basis of administrative priority, as the matters raised were likely to be addressed in the forthcoming market review (i.e. what became the 2008 BCMR). Ofcom's email stated:

“In reaching this decision, Ofcom has not considered the merits of THUS's allegation that BT's WES/WEES Ethernet product portfolio is discriminatory and not cost oriented, in contravention of SMP conditions HH1, HH2 and HH3. Ofcom considers the merits of a complaint only once an investigation begins.”

We accordingly do not accept BT's contention that it “was entitled to draw comfort from this email that for 2006/07 it was not obviously in breach of condition HH3”. In any event, the THUS complaint post-dated BT's setting of prices for 2006/07 and BT does not state that it actually relied on Ofcom's response to the complaint by THUS when seeking to interpret and apply condition HH3.1. Accordingly, we see nothing in Ofcom's treatment of that complaint which advances the issue.

(c) Mechanistic assessment

143. BT further characterises Ofcom's approach in its skeleton argument and written closing as “automated” and “formulistic”. In the Determination, Ofcom stated:

“9.221 ...For the purposes of resolving these Disputes we do not consider average charges compared to average DSAC across the whole period, as we suggested might be relevant in the 2009 PPC Determinations. We believe our approach is appropriate given the importance placed by the CAT on the DSAC test and its findings in relation to treating charges above DSAC as “intrinsically excessive”. Further, the use of the dispute period as a whole as the basis for calculating the averages is largely arbitrary, particularly in this case where services are in dispute for different periods.

9.222 However we do place weight on the factual context for the failure of the DSAC test. In cases where charges are above DSAC for a limited period, and by a relatively small amount, or well below DSAC both before and after this limited period, we take account of the factual context when assessing overcharging.

9.223 In relation to BT’s argument that Ofcom had never given any indication that there could be a breach of the cost orientation obligation in respect of a single year, we would expect BT to be compliant with its regulatory obligations at all times. We gave no indication in the NCC Guidelines, the 2004 LLMR Statement or the 2008 BCMR Statement that we would only find that BT had breached its cost orientation obligations where prices had exceeded DSAC for a certain period. Further, BT’s RFS are reported on the basis of each year’s cost and revenue data, rather than as a weighted or moving average over time. We therefore do not consider that BT could have expected anything other than to have to demonstrate that its charges were at all times compliant with its cost orientation obligations, including for a single year.” (internal footnotes omitted)

144. The reference to the “CAT” in para 9.221 is to the Tribunal’s approval, in the *PPC* CAT judgment, of DSAC as the best measure for assessment of compliance with a cost orientation obligation. We return to that analysis when considering Sky/TalkTalk’s Ground 1, below.
145. Mr Myers elaborated, under cross-examination by Mr Graham Read QC, appearing for BT, on the reason for not adopting an averaging approach:

“Mr Read: My question is a simple one: why is it that Ofcom does not look at the average over the period? If it did, BT would be compliant for those four years?”

Mr Myers: As you pointed out, there were things changing over the period. Prices certainly changed in 2009/10, there were not such large changes in other years, but as you pointed out there were significant changes in the year by year costs, very significant changes on these numbers between each of the years. I think that would create circumstances - costs circumstances in this case or cost and revenue circumstances in 2009/10, that were very significantly different between each of these years. In that context, averaging runs a significant risk of averaging together two rather dissimilar things and reaching a false conclusion, that conclusion about a false negative conclusion I was being asked to comment on earlier by Mr. Thompson, as a consequence of averaging different things together. Ofcom's approach was a different approach which addressed the same underlying concerns that lead one, or might lead one to - or the argument is made that one should average, which is to look at the year by year costs and invite an explanation

of why, in this case, the costs are so different between, for example, 2006/07 and 2007/08 - in other words, look at the specific circumstances. So I would say, therefore, to summarise that, two points: Ofcom's approach by looking at the evidence on a year by year basis addresses effectively the same underlying concern which is the proponents of averaging across years are leading them to that view, but it avoids one of the disadvantages of averaging, which is that it may hide overcharging in one year by combining it with something that's comfortably below DSAC in a different year."

146. We do not regard Ofcom's approach, as set out in particular in para 9.222 of the Determination and explained by Mr Myers, as "rigid", "automated" or "mechanistic". On the contrary, we consider it is an entirely acceptable approach, within the regulatory judgment of Ofcom.

147. When it came to assessment of whether BT had in fact overcharged, Ofcom considered, case by case, each charge that failed the DSAC test to ascertain if there were specific circumstances which meant that the charge was, nonetheless, cost oriented. Ofcom did this applying the approach set out above: see at para 14.19 of the Determination. Ofcom's analysis, set out in detail for each BES and WES charge in dispute, comprises 238 paragraphs in section 14 of the Determination: paras 14.74-14.311. Thus, as regards the five specific instances alleged by BT to demonstrate an inflexible approach:

(i) BES 100 rental in 2009/10: Ofcom noted that this was the fourth year in succession where BT's charge for this service exceeded DSAC. Although BT had reduced the charge, which was now only slightly above DSAC, BT had not put forward any specific evidence that it had expected the unit DSAC to be such that its charge would be below DSAC: see the Determination at paras 14.88-14.92. We observe that the extent of overcharging found by Ofcom was in any event only £200,000 in this case – a small figure in the overall context.

(ii)-(iii) BES 100 connection in 2006/07 and 2007/08: We have addressed the issues concerning 2006/07 above. Ofcom found that the margin by which this charge exceeded DSAC and FAC that year was very substantial: 284% and 419%, respectively. And as regards 2007/08, although the RFS showing the disaggregated figures for 2006/07 was not available when the charge was set for that year, BT had the necessary data by August 2007

showing that the charge was above DSAC but Ofcom found that BT could not explain why it then failed to take action to reduce this charge until September 2008. See the Determination at paras 14.169-14.181.

(iv) BES 1000 connection in 2006/07: BT correctly points out that the charge for this service was above DSAC for only one of the four years under consideration. However, Ofcom expressly took that point into account and the Determination reflects the close attention given to this charge: paras 14.187-14.211. Ofcom noted that BT's charge was not marginally out of line with costs but considerably so: BT's price was 222% of DSAC and 289% of FAC. Even if full costing data was not available to BT at the time, an excess of this magnitude indicates that the risk that the charge was not cost oriented should have been apparent. In an effort to undermine that reasoning, BT, in cross-examination of Mr Myers, pointed to the RFS for 2006/07 that showed a much lower excess, and sought to suggest that the higher figures in the Determination resulted from an adjustment made by Ofcom with regard to payment terms in the 2009 LLCC. However, the Determination shows that the significant adjustment to the RFS figures was to correct an error which BT itself identified during the dispute resolution process, due to an inconsistency between the volumes used to derive component unit costs and the volumes used to distribute those costs to the services: Determination at Table 13.14 and para 13.113. This point therefore does not weaken the thrust of Ofcom's analysis. Further, a significant reason for the price not exceeding DSAC in subsequent years was a change in cost allocation methodology by BT which significantly increased the amount of DSAC allocated to BES 1000 connection.

(v) WES 10 rental in 2008/09: Ofcom's analysis of this charge is set out at paras 14.213-14.245 of the Determination. Ofcom found that the reason WES 10 rental failed the DSAC test for the first time in 2008/09 was because of BT's price increases. Further, although unit DSAC fell in 2007/08, that was principally due to the removal of costs associated with main link rental, so Ofcom found that a drop should have been anticipated.

And when the 2007/08 RFS was published in September 2008, showing the extent of the reduction in unit DSAC, BT took no steps to reduce its prices for the balance of the 2008/09 year. Mr Myers was cross-examined about Ofcom's approach to this particular charge, and we found his answers were impressive in their explanation of the care with which Ofcom looked at this case.

148. The above is only an abbreviated summary, identifying some of the features referred to by Ofcom in the Determination when addressing these five cases. However, we consider it is sufficient to illustrate that Ofcom indeed applied a fact-sensitive (and, indeed, fact-intensive) approach to its analysis of individual charges, and did not adopt a rigid, inflexible approach of automatically finding breach of the cost orientation obligation just because a charge was above DSAC. The weighing up of the various specific factors before concluding that the obligation was breached in a particular case represents, in our view, a classic exercise of regulatory judgment with which this Tribunal should not interfere.

**D. Sky/TalkTalk's Ground 1**

149. Sky/TalkTalk do not object to the application of the DSAC test as such to individual services, but allege that, on its own, that test is manifestly insufficient since if BT priced all its Ethernet services at their DSAC, that would result in multiple recovery of its common costs. Condition HH3.1 permits only "an appropriate mark-up for the recovery of common costs". Therefore a further test is required to prevent significant over-recovery of common costs and, without such a test, Sky/TalkTalk contend Ofcom's approach was "unlawful": Notice of Appeal, para 47. Although Sky/TalkTalk sought to avoid suggesting that there was one specific test that Ofcom should have used, they made clear that what was required was a FAC-based test at an aggregate level. No doubt recognising that if they did not present a clearly articulated test it would be difficult for the Tribunal to assess the strength of their case, Sky/TalkTalk expressed the test in their skeleton argument as a test "to require that BT's charges across Ethernet services generally (i.e. BES, WES and main link) must not *in aggregate* exceed FAC" [i.e., the FAC of those services considered together].

150. The details of Sky/TalkTalk's preferred approach were elaborated in the evidence of their economic expert, Dr Houpis. It involves a two-stage test. First, Ofcom's DSAC test should be applied: the charge for any individual service which was above DSAC should be reduced to DSAC. Secondly, the charges for services (either the actual charges if they were below DSAC or the charges adjusted down to DSAC) should then be aggregated in proportion to the volume sold and compared to the aggregate FAC of all BT's BES and WES services. An extract from Dr Houpis' first report, setting out the test and illustrating its application, is appended to this judgment.
151. However, Sky/TalkTalk's objection to Ofcom's interpretation and application of Condition HH3.1 applied only when no charge control was in place. Once services were subject to charge control in addition to cost orientation, the charge control would prevent over-recovery of common costs. Thus, Sky/TalkTalk acknowledged from the outset that its objection ceased to apply when low bandwidth Ethernet services became subject to charge control.<sup>31</sup> This of course meant that the application of Condition HH3.1 would involve a different approach before and after the imposition of a charge control by the 2008 BCMR Statement (implemented through the 2009 LLCC Statement), but that was the result of there being other restraints on BT's pricing ability.

(i) *Measures of cost*

152. There are essentially four relevant measures of cost, reflecting the different bases on which a cost obligation could be evaluated. They are summarised at para 74 above, but it is important to appreciate their respective significance.
153. The first basis is in relation to the cost associated with the provision of an additional increment of the service in question. The long-run incremental cost (LRIC) reflects both additional short-run variable costs and fixed costs which become variable in the long-run. The LRIC therefore incorporates the additional

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<sup>31</sup> High bandwidth services were thereafter no longer subject to cost orientation since Ofcom found that this was then a distinct market in which BT ceased to have SMP: paras 49-50 above.



costs that are associated with an increase in the volume of the service, or the provision of a new service.

154. The LRIC does not cover all of the costs incurred because some of them are not directly affected by changes in the amount of service provided at the margin. They are costs that are incurred irrespective of how much of the service in question is delivered. For example, there may be central overhead expenditures that are associated with running the business which are borne irrespective of the amount of a particular service offered. These costs need to be recovered from the charges levied, which is why Condition HH3.1 provides for a mark up over LRIC for recovery of these common costs.
155. However, there are various methods by which such costs can be allocated. We emphasise that there is no one “correct” method of allocating costs nor is one method inherently superior to the others. The appropriate allocation of common costs is dependent on the purpose for which the cost information will be used. For a firm that comprises a group of services, a relevant question is whether the firm is earning an excessive return on its assets. For this purpose it is appropriate to allocate the overheads of the business according to some criteria (e.g., proportionately to the volumes of the different services) and then to evaluate whether the return earned on the services, net of the incremental and the allocated overhead costs, is high in relation to a reasonable return on the capital employed. This is the traditional way in which the performance of a service or group of services is evaluated and it is the basis of the second measure of cost, namely FAC.
156. FAC provides a different measure of cost performance from that which is required to determine the cost recovery that would be needed to provide sufficient inducement for an existing firm to offer an additional service. In delivering the new service, a firm that is already present in related markets will incur only the incremental cost of providing the additional service (i.e. LRIC), since the common costs are already being incurred in the related markets. In contrast, for a new entrant the common costs as well as the incremental costs will be incurred, namely the stand-alone costs (SAC) – the third measure of cost. The cost of entering a

new market is therefore in excess of (and can be substantially in excess of) the incremental cost of the provision of a new service by an incumbent firm.

157. Where there are multiple services provided in the market, the problem is further complicated by the fact that a new entrant might combine different services and spread the common costs in different ways across the services it is providing. Entry into the market would be more likely to occur if the amount that can be earned is in excess of the common costs associated with the services and the incremental costs of the individual services. For example, in providing two services the common costs as well as the incremental costs could be recovered in the charges for one and only the incremental costs in the charges for the other, or vice versa. Therefore, in seeking to establish whether prices are high (or low) to encourage entry into a market, the incentives to enter in different combinations of service provision have to be evaluated and prices should not be in excess of the costs incurred in providing any combination of those services.
  
158. This so-called “combinatorial” approach to evaluating whether charges are excessive in relation to those that are required to encourage entry is clearly difficult to apply in markets where there are a large number of services being offered. Instead, simplifications have been sought that approximate the conditions associated with combinatorial tests. One that has been used in telecommunications regulation is the distributed stand-alone cost (DSAC) – the fourth measure of cost evaluation. DSAC takes common costs that are incurred over and above the incremental costs and distributes them according to some criterion, such as volumes across the *relevant* services in the market. It does not, as in the case of FAC, distribute costs across the entire business or over several groups of services or markets, but across a particular group of related services in the market in question. While it therefore distributes common costs across several services, it still restricts the common costs to a narrower set of services than those in which the incumbent firm is engaged. The DSAC, while not as high as the SAC, is therefore in general well in excess of either the FAC or the LRIC.

(ii) The PPC CAT judgment

159. As set out in the discussion of BT’s Ground 3 above, Ofcom did not exclusively rely on DSAC, in that it considered whether individual charges *above* DSAC might still comply with Condition HH3.1. To do this, Ofcom looked at a number of factors, including FAC. But, if a charge was *below* DSAC, Ofcom accepted that the condition had been fulfilled.
160. In defence of its use of the DSAC test in that way as the benchmark for cost orientation, Ofcom relied on the *PPC CAT* judgment. That was an appeal by BT against Ofcom’s determination of a dispute with a number of communications providers, in which Ofcom, applying the DSAC test, found that BT had overcharged for 2 Mbit/s trunk services supplied for PPC circuits (the *PPC* determination: see paras 85 to 87 above).
161. In that judgment, the Tribunal referred to the LRIC and SAC cost measures and noted the problem of common costs in the case of a multi-product firm like BT. The Tribunal observed (at [82]-[83]):
- “82. Some method of ensuring that common costs are recovered – but not over-recovered – is clearly essential. ...
83. In short, whilst it is obvious that if a multi-product firm prices at LRIC it will make a loss (because there will be no recovery of common costs), and if it prices at SAC it will make an unreasonable profit (because there will be multiple recovery of common costs), it is much less obvious how common costs are to be treated.”
162. After discussing the cost orientation obligation on BT (there Condition H3.1, which was identically worded<sup>32</sup> to Condition HH3.1) and explaining the concepts of combinatorial testing, FAC and DSAC, the Tribunal proceeded to consider whether DSAC was an appropriate test for cost orientation purposes: paras [277] et seq. It is appropriate to quote parts of that section of the judgment:
- “285. No-one suggested that DSAC was a conclusive indicator that common costs have been appropriately allocated. It was common ground that a charge for a service could be cost orientated even though it was in excess of the DSAC ceiling, and equally a charge below DSAC might not be cost orientated...”

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<sup>32</sup> Save only that the products to which it applied were identified by reference to Condition H1, not Condition HH1.

286. By the conclusion of the hearing, it appeared that BT did not dispute that DSAC could be an appropriate test for cost orientation. To the extent that BT maintained its contention (made in paragraph 135 of its Notice of Appeal) that DSAC “is fundamentally flawed from an economic and regulatory viewpoint”, we reject it. In actual fact, as a method for dealing with the allocation of common costs, DSAC was, in the case of PPCs, the most practicable option:

- (1) Combinatorial testing ... was simply not practicable.
- (2) FAC could have been used as a means of fully allocating common costs, but would have effectively imposed a single price on BT for its PPC services. Had BT decided to meet its cost orientation obligations under Condition H3.1 by using FAC, then we consider that this would have been an appropriate approach for BT to adopt, and one that OFCOM would not have been able to challenge had it been adopted. But, of course, its very inflexibility is the reason why BT would not have adopted it. Had OFCOM sought to use FAC as the test for BT’s compliance with Condition H3.1, then we consider that this would not have been an appropriate course, for precisely the same reason. (We stress that there was never any suggestion that OFCOM would take this course.)

287. In short, we find that the use of DSAC as a test for cost orientation was not only entirely appropriate, but actually the only satisfactory available course open both to BT (in seeking to comply and show compliance with Condition H3.1) and to OFCOM (in seeking to monitor that compliance). Of course, OFCOM would, no doubt, be open to considering fresh alternatives to DSAC, were such to emerge. ...”

And at [307(3)], the Tribunal stated:

“BT’s third contention was that OFCOM treated prices above DSAC as intrinsically excessive and in breach of Condition H3. Our conclusion is that this is precisely what Condition H3.1 requires. ...Condition H3.1 entitles the regulated firm to mark up prices that have reasonably been derived from LRIC by an appropriate amount to reflect the recovery of common costs and a reasonable return on capital. In this case, DSAC represented the best single measure for assessing whether the condition had been satisfied and so marked the upper limit or ceiling on the permissible mark up of prices.”

163. Sky/TalkTalk sought to distinguish the *PPC CAT* judgment on the basis that it concerned only an individual product (i.e. 2 Mbit/s trunk service) and not the potential over-recovery of common costs across a group of services as in the present case. But even if a different approach were justified where only a single product was in issue, that was not in fact the position in the *PPC* determination. The CPs who had there referred to Ofcom their disputes with BT complained of overcharging also on four other PPC services, including 140/155 Mbit/s trunk services. It was on the basis of its DSAC test that Ofcom found that the complaints of overcharging on those other services was not made out: see para 5, fn 1 to the *PPC CAT* judgment. As Ofcom points out in its closing submissions in

the present case, if Sky/TalkTalk's criticism of Ofcom's approach is well founded, it would have been necessary to apply an additional, aggregate FAC test across those services both to determine whether the charges on the four other services were cost oriented and also to calculate the correct level of overcharge on 2 Mbit/s trunk services.

164. Ofcom emphasises the identical wording of the cost orientation condition that applied in the *PPC* case with that in the present case, and that the condition in *PPC* was also imposed pursuant to the 2004 LLMR. However, neither Sky nor TalkTalk were parties to the *PPC* case, and the CPs which referred those disputes to Ofcom and intervened in the appeal (including the three Altnets in the present case) did not challenge Ofcom's approach on the basis that it was inappropriate as enabling over-recovery of common costs. BT was the only appellant, and obviously this is not an argument that it would put forward. Thus although the *PPC* CAT judgment is significant as an endorsement by the Tribunal of the DSAC test for cost orientation, the argument now advanced by Sky/TalkTalk was not there raised or considered. All that can be said is that Ofcom's use of the DSAC test in the present case is consistent with its approach in its *PPC* determination; and that if Sky/TalkTalk's argument is correct, then that determination also would appear to be flawed.

(iii) "Appropriate" recovery of common costs

165. Sky/TalkTalk maintained that the DSAC test leads to over-recovery in that there is multiple recovery of common costs associated with different services or groups of services. In their closing submissions, they stated: "it is common ground that the DSAC cost standard permits substantial multiple recovery of common costs. In the present case it would have permitted BT to earn a return on capital employed ("ROCE") of some 36% - over three times its weighted average cost of capital ("WACC")". So, for example, if the common costs are distributed across the WES group of services in order to promote entry into that group of services, and also across the BES group of services to encourage entry into that group of services, they will have been recovered twice across the two groups of services combined.

166. In the course of the hearing, Ofcom produced two tables on the rate of return that BT earned on its AISBO services. They were computed using current cost accounting (“CCA”) operating costs, so that in effect they employ a FAC basis for computing the rates of return. Ofcom and Sky/TalkTalk agreed that the relevant cost of capital against which to evaluate the return on AISBO services was BT’s overall cost of capital of 11.4% in most of the relevant years (and 12.3% in the first year). The tables therefore directly address Sky/TalkTalk’s point about whether excess returns were earned in relation to capital employed on a FAC basis.
167. It is unfortunate that this information was provided only in the course of the proceedings, in response to a table put in on behalf of Sky/TalkTalk, and not included in the Determination. In addition, while overall rates of return across all services are useful, similar analyses could have been done on individual and groups of services. Ofcom itself argues for disaggregated analyses, but has not produced average rates of return across the period as a whole for individual services. It is therefore unsatisfactory that the Tribunal is left with an incomplete picture of performance against FAC and over time.
168. Nevertheless, on the basis of the evidence that is available to the Tribunal, these tables show returns on external revenues over the period between 2005/06 and 2008/09 of 28% and 36% (before repayment of overcharging in relation to DSAC), and of 17% and 22% (once repayment of overcharging in relation to DSAC has occurred).<sup>33</sup> This means that BT was earning a return on its Ethernet services in relation to other customers of between 1½ and 2 times its normal cost of capital once repayment for overcharging has been made.
169. Taking BT simply as a provider of both WES *and* BES, there has therefore been over-recovery. However, in relation to potential entrants into either the WES or the BES sectors individually, there has not been over-recovery once repayment for overcharging in relation to DSAC has been made. By definition, BT will then not have earned a return in excess of a normal return on costs relevant to potential

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<sup>33</sup> In each case, the lower figure is derived using BT’s unadjusted RFS data; the higher figure uses Ofcom’s model but excluding those bandwidths in 2006/07-2008/09 for which Ofcom used a cost proxy.

entrants, namely DSAC on individual AISBO services, and it will have earned less than DSAC on some.

170. Therefore, the issue raised by Sky/TalkTalk concerns, in essence, the meaning of “appropriate mark up for the recovery of common costs” within the terms of Condition HH3.1, when the operator with SMP is not subject to a charge control. Sky/TalkTalk's position is that multiple recovery of common costs cannot constitute an “appropriate mark up”. In our judgment, however, the resolution of this issue depends upon the perspective from which appropriateness is being determined. As we explain above, with regard to the LRIC, FAC, DSAC and SAC bases on which to measure the cost of a set of services (the SAC being greater than DSAC which is greater than FAC, which in turn is larger than LRIC): (i) the LRIC is appropriate for evaluating the costs of the provision of an additional service for a firm that has already incurred the common costs; (ii) the FAC is appropriate for evaluating whether a firm is earning a reasonable return across all its services; (iii) the DSAC is relevant for evaluating whether a firm will enter into the provision of a group of new services; and (iv) the SAC is appropriate for establishing whether it will enter into the provision of a single service.

171. The appropriate basis on which costs should be determined therefore depends on the issue that the relevant cost measure is seeking to address. As Etherton LJ stated (with the concurrence of Rix and Lewison LJ) in the Court of Appeal in the *PPC CA* judgment as regards the identically worded Condition H3.1, at [68]:

“The issue is what, for the purpose of Condition H3.1, was “appropriate” on the facts and in the overall context of the regulatory purposes of the Condition and the overall scheme of the [2003] Act and the CRF to which the Act was intended to give effect.”

172. It is therefore relevant to consider the explanation for the imposition of the cost orientation obligation in the 2004 LLMR. The basis for the imposition of regulation at the wholesale level was set out in para 7.10 of the 2004 LLMR:

“Regulation at the wholesale level is designed to address the problems which result from the existence of SMP in the relevant wholesale market. In particular it is designed to ensure that the SMP at the wholesale level does not restrict or distort competition in the relevant downstream markets or operate against the interests of consumers, for example through excessively high prices....”

173. The basis for setting cost orientation obligations in the AISBO markets was described in para 7.54:

“As BT has been identified as having SMP in this market, the availability of wholesale AISBO services at cost oriented prices would help to ensure that the resulting competition in the retail leased lines markets and other downstream markets should lead to lower prices.”

174. The 2004 LLMR proceeded to summarise the terms of the cost orientation condition. and stated, at para 7.61:

“It enables competitors to purchase services at a rate which will enable them to develop competitive services to the benefit of consumers, whilst at the same time allowing BT a fair rate of return which it would expect in a competitive market. The potential for a degree of flexibility envisaged in the approach to the recovery of cost of capital recognises that some investments will carry a higher degree of risk than others and does not remove incentives for the development of new services.”

175. The reason for rejecting the imposition of price controls, urged by some of the respondents to Ofcom’s consultation, was explained in para 7.63:

“Ofcom is of the view that it is not currently necessary to impose a price control on AISBO products. The AISBO market is in a relatively early stage of development and it is necessary to give time for the effects of the cost orientation obligation to impact on the competitiveness of the market before considering whether a price control is necessary. The need for a price control will be considered when the market is next reviewed.”

176. Sky/TalkTalk submitted that the phrase “the competitiveness of the market” in the second sentence of para 7.63 must be a reference to the downstream, retail market. We do not agree. The obvious reading of this sentence is that “the market” is the AISBO market identified at the beginning of the sentence, i.e. the upstream, wholesale AISBO market, in which BT was found to have SMP.

177. Where competition in a market is emerging, a fair rate of return should not exceed that required to promote entry into the market, i.e. the cost of entry – SAC or DSAC. It can lie anywhere between that and the return at which it is no longer profitable for firms to remain in the market, i.e. the incremental cost – LRIC. If entry is required to establish a competitive market, competition between new entrants and the incumbent requires prices to reflect the overhead costs of entry as well as LRIC, i.e. SAC or DSAC, depending on whether entry occurs at the level of individual products (or services) or combinations of them. A cost orientation



obligation based on DSAC is therefore consistent with Ofcom's rationale of promoting competition in the AISBO market.

178. The application of FAC based pricing would only have been appropriate for encouraging the entry of firms that could replicate the entire range of services provided by BT in the relevant markets (i.e. all those services of which the costs were aggregated under the test<sup>34</sup>) and therefore could benefit from all the economies of scale and scope that BT enjoys. Unsurprisingly, entry even in the provision of the full range of AISBO services is extremely unlikely. On a realistic view of a potential entrant, it would incur the higher costs associated with the more limited set of services over which it can spread its common costs, and DSAC therefore provides an appropriate cost basis.
179. The advantage of cost orientation is that it allowed BT to set its prices in a nascent market in relation to its own expectation of costs. This allowed prices to be dynamic, as the market developed and costs changed as a result of increasing volumes. This could not have been achieved with price control, which would necessarily have been set based on projected costs over an extended period. Projecting costs in a nascent market, as the AISBO market was in 2004, would have been difficult because of uncertainty over the speed with which volumes would grow; Ofcom could have adversely affected the development of the market, if a "price cap" had been set incorrectly. On the other hand, the danger of cost oriented prices is that since prices are measured in relation to outturn rather than predicted costs, there is less incentive for firms to try to reduce their costs. This would result in higher prices, which may encourage dynamic efficiency (as a consequence of the lower risks associated with new investment), but is likely to reduce productive and allocative efficiency because of higher costs than would have been likely under price cap regulation.<sup>35</sup>

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<sup>34</sup> Dr Houpis' preferred view appeared to be that the grouping or basket of services to which the aggregate FAC test should apply was all services on the AISBO market, i.e. BES, WES and main link: see, e.g. the Appendix, para 4.14. But on occasions in his evidence he suggested it could comprise all BT services subject to cost orientation.

<sup>35</sup> See para 75 above for an explanation of productive, allocative and dynamic efficiencies.

180. Sky/TalkTalk argued that Ofcom did not foresee any entry into the wholesale market at the time of the 2004 LLMR. They refer to Ofcom’s findings in that market review that there were strong barriers to entry in the AISBO market, in particular because of BT’s substantial sunk costs. For example, Ofcom stated: “by self-supplying SBO [i.e., symmetric broadband origination], communications providers are unlikely to be able to compete with BT’s retail charges for LES circuits in many instances” (para B.434). Ofcom found that: “The prospect of widespread entry by new firms appears to Ofcom to be limited” (para B.435); and concluded that: “... there are no developments that would generate sufficient competitive pressures within the next 2-3 years to alter the current finding of SMP” (para B.442).
181. However, those statements are part of the assessment in Annex B of the 2004 LLMR of whether BT had – and would be likely to retain – SMP on a forward-looking basis. We do not regard them as inconsistent with the view that there was the potential for *some* market entry at the wholesale level. Ofcom’s conclusion that BT was likely to continue to have SMP therefore did not preclude it from nonetheless considering that it should seek to stimulate the AISBO market by providing the right conditions to encourage as much competition and entry as possible in this developing market. In the event, the view that there were some prospects for entry was clearly not fanciful: entry did occur following the 2004 LLMR in a limited segment of the market, namely the high bandwidth AISBO market. As a consequence, when reviewing market conditions in the 2008 BCMR, Ofcom found high bandwidth to constitute a distinct market in which BT no longer had SMP.
182. Accordingly, as Ofcom regarded the development of the AISBO market as an important objective of cost orientation, it was appropriate to base evaluation on DSAC rather than FAC.
183. Balancing the various forms of economic efficiency (see para 75 above), and in particular determining the appropriate trade-off between the benefits of increased access-based competition in downstream markets and the potential for more competition in the upstream AISBO markets, involves an exercise of regulatory

judgment. We do not see, on the evidence before the Tribunal, that Ofcom can be found to have erred in its approach such that this Tribunal should interfere.

184. Sky/TalkTalk also submitted that the underlying statutory provisions meant that the correct interpretation of Condition HH3.1 precluded Ofcom’s reliance on the DSAC test as the benchmark for compliance. Pursuant to sect 88(1) and (3) of the 2003 Act, Ofcom can only set a cost orientation condition when it appears to it that there is a risk that the dominant provider (here, BT) might charge excessive prices (or impose a price squeeze, but that was not the consideration in this case). Accordingly, Sky/TalkTalk argued that the cost orientation condition should be interpreted in a manner that would prevent excessive prices. In their submission, applying only a DSAC test would not do that, since it inherently permits significant over-recovery of common costs.
185. We do not accept this submission. The risk of adverse effects from price distortion is a necessary pre-condition for the imposition of a cost orientation obligation. In the present case, the relevant adverse effect was the maintenance of excessively high prices. But identification of that risk does not in and of itself permit the imposition of a cost orientation obligation. The statute prescribes, at sect 88(1)(b), a further requirement. It must also appear to Ofcom:

“... that the setting of the condition is appropriate for the purposes of—

(i) promoting efficiency;

(ii) promoting sustainable competition; and

(iii) conferring the greatest possible benefits on the end-users of public electronic communications services.”

Further, sect 88(4)(b) states that in considering those matters, Ofcom may:

“determine what they consider to represent efficiency by using such cost accounting methods as they think fit.”

186. Thus in seeking to curb excessive pricing, Ofcom may only impose an obligation that is appropriate for these broad purposes. We consider that the statutory regime clearly permits Ofcom to respond to the risk of excessive pricing by imposing a regulatory control that seeks to promote upstream entry into the market, thereby

curtailing the power in that market of the dominant company. Such enhanced competition, or put another way, a more competitive market, will lead to the avoidance of excessive prices over time. Indeed, by 2009, entry into the provision of high bandwidth AISBO services had eliminated the SMP which BT had previously held in that segment of the market.

187. In short, Sect 88, read as a whole, does not require Ofcom, in its response to a risk of excessive prices, to impose obligations that will immediately produce the lowest price. An excessive price is a price that is inconsistent with the price that would be expected in a competitive market. As we have explained, for this market, a price up to DSAC may be a price for promoting competition in the market: see at para 177 above. A cost orientation obligation that brought prices down to DSAC can be regarded as appropriate to promote dynamic efficiency and thus the purposes specified in sect 88(1)(b). Accordingly, applying cost orientation on the basis of a DSAC test was well within Ofcom's statutory discretion.
188. Consideration should also be given to the practical difficulties encountered in the application of the proposed aggregate FAC test:
- (a) The test would be dependent not only on price movements, but sales volumes of any of BT's products in the relevant markets (i.e. the products included in the aggregated basket for application of the test), the cost of new products and technologies being developed and changes to BT's costs base. All these factors would affect the proposed aggregated FAC test with the result that changes would have an impact across the entire range of BT's prices in the relevant markets at the same time.
  - (b) There is an asymmetrical effect for BT. Overcharging would result in a repayment of the overcharge, but under-charging could result in amounts being incapable of being recovered. The impact could result in economic inefficiency if prices were below FAC.
189. Dr Houpis sought to address these difficulties by stressing that, if the test he put forward was to be applied across the group of Ethernet services subject to cost

orientation, it would have to be applied flexibly, allowing various justifications for pricing above FAC. However, pricing models, based on cost recovery, are dependent upon assumptions regarding projected future costs and volumes, since prices are set ex ante, whereas actual cost is determined ex post. Accordingly, to apply such an aggregate FAC test would require a complex set of calculations relating to many of BT's activities. Irrespective of the flexibility built into the model, we think that this raises serious practical problems in the application of the test, potentially over an extended period of time, as demonstrated by Dr Houpis' answers to questions from Mr Harrison:

“So what happens, let's take a hypothetical, that the test is in place, then what I would expect BT to do is to look at the range of cost orientated services. It will have a view as to what the FAC of those services is and it will try and set a set of prices based on its best forecast of volumes, etc., for that. Okay? That is the ex-ante. Then demand happens, volumes happen, costs clarify, and then BT will see how the revenue is compared to FAC. Now, let's say that ... what happens is one group of cost orientated services shows that the revenues in relation to FAC are 10% higher, because of the kind of uncertainty you mention. Now, in principle communication providers could come and say, "There is a breach here. It is supposed to be at FAC and it is 10% higher". What I would expect to happen is that BT, if that was the case, a case is brought, the appeal will go to Ofcom and say, "Hold on a second, we did our best. We forecasted our costs to the best of our ability. We forecast the volumes to the best of our ability and we set our prices on that basis". Now, we are not able to perfectly forecast volumes. I totally accept that. I totally accept there is uncertainty and I think it is a reasonable case for Ofcom on that. I do not see why Ofcom would apply another charge if revenues, in that example, were found to be above FAC, say, by 10%.

...

I think the test would apply in individual years, but when Ofcom comes to take a view, it would have to take into account, if there have been a number of years where this test has been running, there could be relevance of the period over which this happened. I think that would become a relevant factor. Would it actually in practice be binding? I don't know, but over time I would expect that if BT could show consistently that sometimes it was above, sometimes it was below and to the best of their ability it was a random event, then I think that will be useful information in terms of Ofcom coming to a view as to whether in a particular year, if for a particular group prices were above cost, that would be relevant in coming to a view as to whether there was a breach or not.”

190. Sky/TalkTalk also adduced evidence from Mr Robinson, an expert economist with experience in financial analysis in the telecommunications sector. As part of his reports, he produced calculations of the level of overcharge on individual services, applying Dr Houpis' FAC-based test. In his oral evidence, Dr Houpis said he

thought his proposal had been implemented by Mr Robinson to show how it affects the prices of individual products.

191. However, under cross-examination from Mr Read, it emerged that Mr Robinson's calculations produced figures for the overcharge of some products that were in excess of the revenues that BT had in fact received for those products. For example, for BES 1000 rental in 2007/08 and 2008/09, Mr Robinson calculated overcharges<sup>36</sup> of £33.7 million and £33.1 million respectively, whereas BT's total external revenues from that service in those two years were only £26.6 million and £28.2 million. The same inherent problem applies to the calculations of BES 100 rental in 2007/08, WES 1000 rental in 2007/08 and 2008/09, and WES 155 rental in 2009/09. Mr Robinson did not think that this was due an error in the calculations but rather was the consequence of the methodology for allocating the aggregate overcharge as between individual services. He realistically accepted that this could not be a sensible result.
192. Shortly after the evidence from all the appellants had concluded, Sky/TalkTalk's solicitors wrote on 14 November 2013 to the Tribunal, effectively withdrawing reliance on this part of Mr Robinson's reports on the basis that his "methodology" was erroneous in not properly implementing Dr Houpis' methodology. That was followed by a further letter sent on 18 November, while the parties were preparing their closing submissions, which set out revised calculations made by Dr Houpis as to how the overcharge calculated on his FAC-based test could be distributed across the different services. This material therefore does not constitute part of the expert evidence in this case: it could not be properly tested by any of the other parties, and obviously could not be put to Mr Robinson or any of the other experts for comment in their evidence. We therefore do not take it into account.
193. Nonetheless, we recognise that there are many different ways in which an overcharge calculated by use of an aggregate test may be distributed across individual services. Although the results set out by Mr Robinson therefore do not in themselves establish a fallacy in the test, they give rise to serious concern. Given that different CPs have differing demands for the various Ethernet services

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<sup>36</sup> Excluding a RAV adjustment.

(some do not use WES and some do not use BES, while those that purchase both do so in varying proportions), the fact that once an aggregate calculation of an overcharge is made across services, the allocation of the result as between individual services is susceptible to such significant variation, suggests that implementation of this test is not a reliable and straightforward procedure.

194. Accordingly, having regard to the purpose for which Condition HH3.1 was imposed, in its statutory context, we reject Ground 1 of Sky/TalkTalk's appeal that Ofcom was wrong to rely on the DSAC test alone to establish the overcharge. We further believe that the alternative approach put forward by Sky/TalkTalk, involving the test advocated by Dr Houpis, would give rise to serious problems of practicality and reliability in its application.
195. We should add that as a further objection to Sky/TalkTalk's FAC-based test, Ofcom submitted that for it to have applied such a test would have been contrary to the legitimate expectation of BT at the time. In response to this, Mr Pickford, for Sky/TalkTalk, made reference in the cross-examination of Mr Myers to a number of regulatory documents produced by Oftel, in an effort to establish that BT should have known that, for a market that was not effectively competitive, cost orientation required prices much closer to LRIC and well below DSAC. In the light of our conclusions above, it is unnecessary for us to reach a view on the implications of those documents, on which the witnesses from BT did not have an opportunity to comment.

## **VIII. ADJUSTMENTS TO BT'S RFS**

196. We have explained the nature and purpose of the annual RFS produced by BT: see paras 42-46 above. In the Determination, Ofcom considered whether any, and if so what, adjustments should be made to BT's financial data as set out in its published RFS when determining whether BT's disputed charges were cost oriented. Ofcom explained in the very detailed sect 13 of the Determination, extending over 350 paragraphs, why it had decided to make each of a number of adjustments but rejected others that had been proposed.

197. By Ground 4 of its Notice of Appeal, BT contends that additional adjustments should be made for three distinct items, which would increase the computation of BT's costs and thus reduce the overcharge. By Ground 2 of their Notice of Appeal, Sky/TalkTalk also contend that an adjustment should be made to BT's RFS but, by contrast, this adjustment would reduce the computation of BT's costs and, therefore, increase the overcharge.
198. Before considering each of these challenges in detail, it is appropriate to make some observations regarding the RFS and the approach that Ofcom adopted regarding adjustments.
199. In allocating costs, cost causality is the key driver. Where costs could be directly attributed to a product or group of products (direct costs), then that is the starting point. However, a significant proportion of BT's cost base is fixed, with costs common to a number of products. Therefore, some form of apportionment of these common costs is required. The allocation of these common costs may represent a sizeable proportion of the costs of a service. Changes in the allocation of common costs are therefore likely to impact significantly on the costs of individual products and services. But the onus of producing the RFS and allocating costs rested on BT. As we have remarked in the discussion of the rentals v. connections issue, BT had significant leeway when there were reasonable alternative views on the appropriate allocation.
200. When BT made changes in its methodologies for allocating costs, these would often have an impact on prior years. However, in presenting the published RFS, it was only the year prior to the change that was restated. Accordingly, this created inconsistencies when comparing costs over a long period of time.
201. As we have already mentioned, BT's witnesses explained in their evidence that the RFS information is not used in the day-to-day financial management of BT. For that purpose, monthly management accounts are used, that show information such as aggregated measures of revenues, costs, profits, ROCE, etc. These were regarded as being more relevant to the issues facing management in the control of its business than the information provided by the RFS. The management accounts



were produced on a timely basis, whereas the RFS information was produced at the end of the third quarter (as a “dry run” for the year end) and was not produced in its final form until several months after the end of the financial year. For these reasons, the RFS provided little value to the operational management of the business.

202. As a result, and unlike traditional financial information, the RFS was not subject to regular operational management scrutiny, which will often identify errors and anomalies that can be corrected at the time. In these circumstances, errors in both the arithmetic allocation of costs and the methodologies for allocating costs in the RFS could arise and remain undetected for a considerable time. Indeed, Mr Dolling and Mr Coulson confirmed that a major cause of restatements of the RFS was the increased focus created by Ofcom’s investigation of the PPC and Ethernet disputes. This led to BT identifying problems in the RFS that had occurred in earlier years. As BT frankly commented in its response to Ofcom’s Provisional Determination:

“It might be said that the errors in the published numbers should have been discovered earlier. Clearly it would have been better had they been, but they were not. In truth the calculation of the DSACs received too little attention by BT and others until the rash of disputes made their significance clear.”

203. Although Ofcom took as its basis the figures in BT’s RFS for the relevant year in determining BT’s costs and revenues, the inherent weaknesses in the RFS resulted in some adjustments to the figures. However, because of the importance of the RFS to the regulatory framework, Ofcom was cautious in its approach to adjustments. Ofcom explained its approach as follows in the Determination:

“11.27 Our starting point for making regulatory decisions assessing compliance with cost orientation obligations which require consideration of BT’s costs and revenues, is BT’s view of its costs, as published in its RFS. As we set out above, we would expect the RFS to contain the best available information for those decisions. However we have adjusted BT’s accounting data on occasion in the past where we considered that this was necessary and appropriate. We have made such adjustments where the published data is in error or based on an obviously inappropriate methodology, to ensure that, as far as possible, we accurately reflect BT’s costs and revenues when resolving disputes and undertaking other regulatory duties.

...

11.29 We can only make adjustments where it is reasonably practical to do so with the evidence available to us. Where we are concerned that data may contain an error or have been produced using an obviously inappropriate methodology, we can only change the data if we have sufficient information to properly address the concern with the published data. If sufficient data is not available to us, the original data in the RFS may still represent the best available information.”

204. Ofcom expressly recognised that making adjustments to the RFS may have certain undesirable consequences, so that the question whether or not to make an adjustment involved a regulatory judgment, balancing these various factors. It therefore developed a framework for making adjustments, which it set out at para 11.39 of the Determination. This involved five factors, which Ofcom stated it was appropriate to take into account in deciding whether an adjustment should be made:

“[1] Does the adjustment correct an error in BT’s published RFS? ...

[2] Does the adjustment correct a methodology used in the published RFS that is obviously inappropriate for the purpose of resolving the dispute? ...

[3] With the available evidence, is it reasonably practical to implement the proposed adjustment to the published data in a way that properly addresses the error or inappropriate methodology? ...

[4] Does the proposed adjustment retrospectively alter the financial data on which we relied in previous regulatory decisions including for services outside the scope of the dispute? ...

[5] Does accepting revised data create inappropriate incentives for BT to produce appropriate and accurate regulatory financial statements in the future? ...”

Ofcom explained that the answer to either (1) or (2), and also (3) must be “Yes” for it to consider departing from the published RFS; and if the answer to (4) or (5) is “Yes” then a judgment is required to balance the competing considerations.

205. In our judgment, this framework for deciding whether or not to make an adjustment is entirely appropriate. Indeed, we did not understand any of the parties to criticise it, as a matter of principle, at least as regards adjustments proposed by BT.<sup>37</sup>

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<sup>37</sup> Sky/TalkTalk contends in its skeleton argument that the framework should apply only as regards adjustments proposed by BT, but in its closing submissions appears to accept that the framework should apply also to its own proposed RAV adjustment: see para 236 below.

206. We should add that because the RFS did not disaggregate data to the level corresponding to BT's charges in its OPL, and although BT provided further information in response to requests from Ofcom, BT could not supply cost data in all respects at the level of disaggregation required. Therefore, Ofcom had to adopt what it regarded as appropriate methods of allocation where detailed cost data was lacking.

**A. BT's Ground 4**

207. BT put forward three distinct adjustments to the RFS figures which it alleged should be made. Those concerned:

- (i) Excess construction costs;
- (ii) Transmission equipment costs; and
- (iii) Provisioning costs.

208. In advancing its case on this ground, BT relied in particular on the expert evidence of Mr Coulson, now a director at Ernst & Young and previously Head of Regulatory Finance at BT. That evidence had not been adduced by BT during the administrative phase while Ofcom was resolving the disputes.

209. Ofcom did not object as such to the admission of that evidence, but in its Defence stated that: "it is for BT to put forward a good reason why its evidence should be admitted" (para 196). That Defence was served three months after BT's Notice of Appeal, and two months after the first CMC in this case. When BT expressly sought clarification from Ofcom of its position, Ofcom stated, by letter of 5 June 2013, that it would not be applying to exclude any of BT's evidence. However, in its skeleton argument for the hearing of the appeals, Ofcom observed that there are practical difficulties when BT raises new evidence in support of adjustments to the RFS in an appeal, and stated:

“It will be a matter for the Tribunal to decide whether it is in the interests of justice for [the new evidence] to be admitted in light of the guidance of the Court of Appeal [in the *08 numbers (Preliminary Issues)* case].”

210. We have to say that we did not find Ofcom’s approach very helpful. In an appeal on the merits, when the parties are all represented and none of them objects to the admission of the new material, the Tribunal will not normally, of its own motion, exclude apparently relevant evidence. If a respondent considers that particular evidence put forward by an appellant should not be taken into account, it should notify the appellant that it is objecting to that evidence, so that the appellant can apply to the Tribunal well before the hearing of the appeal for a ruling in order that, so far as possible, everyone should know where they stand.
211. In the circumstances, we do not think it right to exclude any of Mr Coulson’s evidence and we have accordingly considered it. However, that is a different matter from the extent to which it may be appropriate to set aside any part of the Determination on the basis of new evidence. That is not something on which we would stipulate a hard and fast rule. It will depend in part on the specific nature of the evidence, and such factors as whether it could have reasonably been adduced during the investigative stage, and whether the Tribunal is in a position properly to ascertain to what extent it is correct or whether it might require remittal of the case to Ofcom. The statutory duty of Ofcom to resolve disputes is generally to be discharged within four months: sect 188(5) of the 2003 Act, reflecting Art 20 of the Framework Directive. Although here the time has been extended on the basis of “exceptional circumstances” (which indeed gave additional time to BT to make representations), the statutory timeframe indicates that this is intended to be a relatively speedy procedure and that a second round of investigation should therefore be avoided if possible - and in particular if there was no good reason for a party failing to introduce evidence during the period when Ofcom was considering the dispute that led to the determination.
212. Furthermore, we recognise the asymmetry of information as between BT, on the one hand, and Ofcom and the Disputing CPs, on the other. Since BT did not attempt to demonstrate that it satisfied the cost orientation obligation by analysing its individual charges against relevant costs, Ofcom had to assume primary

responsibility for conducting that analysis. As a result, BT, which has much greater knowledge and sources of information regarding its own costs, not only provided the data underlying Ofcom's analysis but also was in a position to scrutinise Ofcom's calculations of the overcharge, and will inevitably have done so seeking signs of overstatement not understatement. Where BT sets out its basis of criticism only on appeal and not during the investigation, the Tribunal should ensure that BT does not unfairly benefit from this situation.

213. Against that background, we turn to address the three particular adjustments urged by BT.

(i) Excess construction costs

214. As mentioned at para 20.6 above, BT levied an excess construction charge (ECC) where an installation of an Ethernet circuit required extra work. The costs associated with ECCs were included in BT's base rental data up to 2009/10. Since ECCs were not subject to dispute, and relate to an ancillary service, Ofcom considered that it should exclude the costs associated with ECCs when calculating BT's rental costs. BT accepted that it was appropriate to exclude such excess construction costs.

215. In the process of calculating what the adjustment should be, Ofcom issued a formal information request to BT on 22 October 2010. Ofcom relied on the figures which BT provided following that request, which included a depreciation cost for 2009/10 of £15 million.

216. On 3 September 2012, BT wrote a long and detailed letter to Ofcom responding to a number of queries and requests that Ofcom had raised during a presentation which BT had made to Ofcom the previous May, following Ofcom's issue of its Provisional Conclusions. At the end of that letter, BT stated with reference to the adjustment to exclude depreciation costs associated with ECCs in 2009/10, that the costs in the RFS had already been adjusted to exclude depreciation relating to ECCs to the extent of £3.3 million. BT said that the £15 million figure which Ofcom had used should therefore be reduced by this amount.

217. In the Determination, Ofcom refused to make this adjustment, stating that it was “unclear” what BT meant by its comment in the letter of 3 September, given its earlier response to Ofcom’s formal request for information.
218. In his first expert report, Mr Coulson explains how this error in the information originally given by BT arose and expands on the way the £3.3 million had already been excluded from the costs of the BES and WES rentals in 2009/10. His evidence in that regard is not really expert evidence at all, since Mr Coulson was involved for BT in the provision of the information in 2010 and so is giving a factual account. In its Defence, Ofcom accepts that on the basis of what Mr Coulson says, it appears that the appropriate adjustment would have been to remove £11.7 million instead of £15 million.
219. Accordingly, this is not a case of BT seeking a new adjustment which it had not put to Ofcom prior to the Determination. Ofcom now does not dispute that the adjustment sought by BT is correct. Moreover, Ofcom could have requested an explanation of what BT said in its letter of 3 September 2012 if it felt that was “unclear”. And this adjustment does not involve any interference with the integrity of BT’s RFS: the removal of the costs relating to ECCs was in itself a refinement of the figures in the RFS and the only issue is whether the adjustment made for one particular year should be amended.
220. We think it is right to allow this further amendment. It should be emphasised that in resolving such disputes Ofcom is not acting as a simple commercial arbitrator but as a regulator in the public interest. Given the circumstances, we do not see that it is in the public interest for what is acknowledged to be an erroneous figure to remain in an assessment of how much BT has overcharged other communications providers and the computation of a resulting order for repayment.

(ii) Transmission equipment costs

221. In the Determination, Ofcom made two adjustments to the treatment by BT of transmission equipment costs. BT’s challenge concerns the first adjustment which covered the years 2006/07 to 2009/10.

222. The purpose of this adjustment is succinctly explained in the Determination, at para 13.123:

“Between 2006/07 and 2009/10, transmission equipment costs were recovered through upfront circuit connection charges but, for accounting purposes, the assets were capitalised and depreciated over the life of the underlying equipment. This meant there was a timing mismatch between the revenues associated with transmission equipment (which were recognised in upfront connection charges) and the costs of transmission equipment (which were spread over the life of the equipment).”

223. BT accepts that it was appropriate to make an adjustment for this purpose. It also accepts that it was appropriate, therefore, to remove the depreciation and capital costs associated with transmission equipment in the RFS. The issue raised on appeal is the methodology employed by Ofcom to derive the costs used in their place.

224. This issue was considered by Ofcom in the draft determination published on 9 February 2012 of the Sky/TalkTalk and Virgin disputes. Ofcom there stated that it proposed to replace the depreciation and capital asset costs relating to the transmission equipment with “the cost of expensing the equipment in the [Profit and Loss Account (“P&L”)] in the year of purchase.” By the latter expression, Ofcom referred to the cost of writing off the full capital cost of the relevant transmission equipment in the year that the connection was made. In that way, the costs as well as the revenue relating to transmission equipment would be recognised ‘up front’.

225. Ofcom then discussed how it sought to derive this cost. In the draft determination, Ofcom stated that:

“12.63 Figures relating to depreciation and MCE are available from BT’s accounting systems. In addition BT provided an estimate of the cost of expensing the transmission equipment in the P&L each year. It did this by taking the annual additions from the asset register and apportioning them between services based on the volume of connections in each year. This method appears to assume that the purchase price of equipment for each service is the same, which may not be the case in practice.

12.64 This apportionment methodology differs from how transmission equipment depreciation and MCE is apportioned to services in the RFS, which uses a weighted approach. Adopting BT’s methodology would mean certain services attracting a level of P&L expenses relating to the write off of transmission equipment that bore

little relationship to the level of depreciation and MCE they were attracting in the RFS (and ultimately the capital cost of purchasing the equipment).

12.65 Consequently we have estimated the cost of expensing the equipment in the P&L each year by apportioning BT's annual additions from the asset register on the same basis as depreciation and MCE in the RFS. We consider that this approach is a more appropriate basis on which to estimate the annual P&L expense."

226. It is notable that in its extensive submissions in response to the draft determination, BT did not take issue with this approach. Nor did any of the Disputing CPs. It is unsurprising that it was therefore adopted in the Determination: see para 13.139.
227. On appeal, BT contends for the first time that Ofcom's approach was not appropriate on the basis that the methodology for apportionment was "in part based on rental volumes, rather than connection volumes" and therefore did not constitute a like-for-like comparison. That is because using MCE and depreciation to allocate transmission equipment costs would allocate costs in relation to the existing stock of assets in any particular year, which would not necessarily relate to the number of connections. BT therefore alleges, as set out in Mr Coulson's first report, that a method of allocation using weighted connection volumes should be used. It claimed this would result in a reduction of the overcharge by £8.5 million.
228. It seems to us that there is no good reason why BT could not have raised this challenge at the administrative stage. Although Mr Coulson said that the problem with Ofcom's approach would not have been clear to "the general reader at BT", even without looking at the detailed exchanges of information with BT that preceded the draft determination (to which Mr Coulson was taken in cross-examination), the draft determination itself is explicit in stating that Ofcom was allocating the cost "on the same basis as depreciation and MCE in the RFS." Since that was an apportionment adopted by BT, those directly involved at BT would have known, or been able to ascertain, what that involved. They should therefore have realised that this would not solely, or even primarily, reflect connections. Accordingly, we do not accept, as was suggested for BT, that this point could not have been challenged earlier or that it could only be identified by "very detailed and complicated assessment" of Ofcom's complex cost model.



229. The position is that BT put forward, through Mr Coulson’s evidence on appeal, a new methodology based on factored connection volumes alone. Where BT fails to challenge Ofcom’s approach on a very specific and technical cost allocation methodology of which it was given notice, we do not accept that it would be appropriate to set aside Ofcom’s approach on an appeal. Moreover, although we can see that Mr Coulson’s suggested methodology may be preferable, we do not regard Ofcom’s approach as “obviously inappropriate”. Ofcom had followed BT’s own approach in the RFS to the allocation of depreciation and MCE associated with transmission costs, which was based on a combination of rental volumes, connection volumes and the price of transmission equipment. BT had evidently taken the view that that was a fair reflection of cost causality. We therefore reject this challenge to Ofcom’s adjustments.

(iii) Provisioning costs

230. Provisioning costs relate to the processing and planning of new customer orders for services.

231. In the administrative phase, BT argued for several adjustments to be made to the RFS in respect of provisioning costs:

(a) For the years 2006/07 and 2007/08, BT had by error not allocated any provisioning costs to Ethernet services, and such an allocation should be made;

(b) For the year 2008/09:

i. Although an allocation was made to Ethernet services, the amount of the allocation was too low in that Ethernet-specific provisioning costs were spread across all services and not just Ethernet services; and

ii. The allocation was made to BES and WES rentals whereas it should have been made to connections.

232. Ofcom rejected BT’s arguments that such adjustments should be made. BT submits that this was “a straightforward error of fact” and/or that where Ofcom’s

decision was based on the principle that this might lead to adjustments elsewhere, that was an error of law: Notice of Appeal, para 279.

233. In the Determination, Ofcom considered the figures provided by BT for provisioning costs reported in the RFS, and concluded:

“13.357 ... we consider it is possible that the provisioning cost component in 2006/07 and 2007/08 did not capture provisioning costs associated with Ethernet services. But the evidence available to us does not allow us to reach a clear conclusion on this point.

13.358 Therefore we do not consider that BT provided us with sufficient evidence explaining how provisioning costs associated with Ethernet services were captured in 2006/07 and 2007/08 to enable us to determine whether the RFS treatment was obviously inappropriate for the purpose of resolving the Disputes...”

234. Ofcom rejected on a similar basis BT’s argument that the provisioning costs that were allocated for 2008/09 were too low: see Determination at para 13.362. Ofcom added that even if it had been satisfied that there were errors in the allocation, it would then need to take into account that BT allocated a large part of the cost to wholesale line rental (“WLR”) products that were subject to charge controls: para 13.363.

235. Subsequent to the Determination, BT has undertaken more work and Mr Coulson gave evidence of how the costs have been understated in 2006/07 to 2008/09, which supports BT’s argument that these costs should be taken into consideration. In his fourth report for these proceedings, Mr Coulson provided further information on where the provisioning costs which had been excluded from the costs of Ethernet services had actually been charged in the accounts. This demonstrated that certain provisioning costs, which could have been allocated to Ethernet services, had been charged elsewhere against other services. Mr Coulson was asked by Mr Saini QC, appearing for Ofcom, whether these costs, which it was proposed should now be allocated to Ethernet services, had been allocated to other regulated services subject to cost orientation or charge control, and responded as follows:

“A (Mr Coulson): Well, I don't know for sure, but I would imagine...that [it] is part of the wholesale analogue services, which is a regulated market for provision of local access lines - copper access lines.

Q (Mr Saini): So there may well be a price control covering that particular product, would that be fair to say?

A (Mr Coulson): Yes, absolutely.

Q (Mr Saini): So would it not be rather dangerous, Mr Coulson, to allow BT to shift these costs over from this price controlled service into Ethernet, because when the price control for that particular service was being set, costs of that service would have been taken into account, would they?

A (Mr. Coulson): Well, what I have done here is identified an error. I think when errors are found, it is important to identify them and understand them. There is then a question about how you deal with that in the context of historic charge controls, which I have not considered, to be honest. But what I would say is that whilst the absolute amount of cost that belongs to another market doesn't change, clearly if you move £2 million from Ethernet and put £2 million into copper access lines it is £2 million. But from a unit cost perspective I suppose it's important to remember that there are thousands of Ethernet services, and probably something like 25 million copper lines in the UK. So the absolute amount would be the same, but the unit cost would be much less significant in any of the copper access services than it would have appeared in the Ethernet.”

236. Accordingly, although there appear now to be good grounds for finding that the costs of Ethernet products were understated as regards provisioning costs, the reallocation of these costs would impact on other products and services which had been the subject of price controls or cost orientation conditions. When asked about Mr Coulson's view that the impact of reallocation should be assessed in terms of unit cost, Mr Myers stated:

“If we think of this in £million terms, what that's saying is, whatever the figure was, [say] £18 million, [it] was taken into account in setting the price control for whichever [service] it was, WLR, say. The argument is, despite the fact that it was taken into account in that case, it should nevertheless still be shifted across into Ethernet. That seems to me to be a clear case of BT getting the £18 million twice. If the principle is established that as long as it doesn't have a material impact ... however "material" is defined, ... on the unit price, one could imagine that there are lots of price control services. We could move small amounts of £million amounts from a series of price controlled services and then, when one adds up that £million amount it could turn out to be quite a significant amount of money. So I find ... the principle troubling. I think it seems more appropriate to me to think of this issue in terms of the £million amounts and being shifted around ...[effectively] being double-counted, being recovered twice.”

237. We broadly agree with Mr Myers' approach. We do not accept that the adjustment is not material. It may be correct that the effect on unit costs would have been

insignificant in relation to copper access lines because of the volumes of the products and services involved. However, we consider that it is the absolute values that are relevant. The absolute amounts are not insignificant and applying Ofcom's framework for adjustments, we find that these adjustments would not have satisfied criterion (4). Accordingly, even if the evidence in Mr Coulson's reports had been available at the time of the Determination, we do not accept that a refusal to make these adjustments represents an error on the part of Ofcom.

238. Finally, as regards the reallocation from rentals to connections of the amount that was charged for provisioning costs in 2008/09, it does not appear from BT's Notice of Appeal that this is pursued as an independent basis of challenge. But if it is, then it concerns the appropriateness of an allocation decision made by BT in its RFS. We think that there is no obviously "right" choice as between connections and rentals when it comes to the allocation of provisioning costs, and we conclude that Ofcom was justified in refusing to adjust in the Determination the allocation which BT had considered was reasonable at the time.

**B. Sky/TalkTalk's Ground 2**

239. In 1997, BT moved from historical cost accounting ("HCA") to current cost accounting ("CCA"). In the RFS, the assets are valued, and their depreciation is charged, on a CCA basis. "RAV adjustment" refers to an adjustment to the figures used in the RFS for copper and duct assets acquired prior to 1997 to bring them into line with the "Regulated Asset Value" calculated on a HCA basis, indexed for inflation. Using an HCA basis produces a lower valuation. In the Determination, Ofcom concluded that it was not appropriate to apply such a RAV adjustment to the figures in the RFS, since at the time Ofcom had never applied such an adjustment to the AISBO market when making regulatory decisions. Indeed, in the 2009 LLCC Statement, Ofcom discussed whether a RAV adjustment was appropriate and concluded that no such adjustment should be made. Ofcom first proposed making a RAV adjustment for Ethernet services in its 2012 LLCC Consultation, and adopted that course in the 2013 Business Connectivity Market Review Statement ("2013 BCMR").

240. By their appeal, Sky/TalkTalk contend that in deciding not to make this RAV adjustment, Ofcom failed to adopt “the most appropriate objective measure of costs”, and was therefore in breach of its statutory obligations as regards the promotion of competition and efficiency.
241. However, we have set out the framework for making adjustments to the RFS applied by Ofcom in the Determination: see at para 197 above. We do not regard the principles in that framework as contrary to Ofcom’s duty to promote competition and, as we observed, those principles were not challenged in general terms in these appeals. We do not accept the submission advanced by Sky/TalkTalk in its skeleton argument that those principles should apply only to adjustments proposed by BT. Although principle (5) is obviously likely to apply only to a change urged by BT, we regard the framework as a whole as of general application, reflecting the importance of maintaining confidence in the RFS and the factors which Ofcom should take into account when considering any particular adjustment. Indeed, we note that in their closing submissions Sky/TalkTalk appears to accept that the framework is applicable to consideration of the RAV adjustment.
242. In 1997, Oftel had determined that assets should be valued on a CCA basis instead of a HCA basis in order to encourage entry and competition. Although in its statement “Valuing Copper Access” issued in August 2005, Ofcom applied a RAV adjustment for certain wholesale services (including TISBO, WLR and local loop unbundled services), those did not include Ethernet services; and when Ofcom expressly considered the application of this approach as regards Ethernet products in the 2009 LLCC it decided that no RAV adjustment should be made, in part because Ofcom thought that there was the potential for a significant amount of future investment in infrastructure used to provide Ethernet services, and so wished prices to reflect the replacement cost of assets in order to encourage efficient investment. Although Ofcom came to change its views in the 2012 LLCC consultation, which led to the adoption of a policy in the 2013 BCMR that a RAV adjustment should apply, that was on a forward looking basis.

243. This brief summary highlights the fact that whether or not to apply a RAV adjustment is a reflection of a policy decision by Ofcom, made on its assessment of the circumstances of a given market at a particular time. Therefore, we consider that it cannot be said that BT's application of depreciation on a CCA basis was "obviously inappropriate." Since that is a threshold condition under the framework for making an adjustment to BT's RFS, we find that Ofcom was not in error in failing to apply a RAV adjustment.

244. We would add that we also agree with Ofcom (and BT) that it is appropriate to consider how BT should reasonably have understood and complied with the cost orientation obligation at the time. In that respect, to amend the RFS retrospectively by a RAV adjustment which did not correspond to Ofcom's policy towards Ethernet services during the period covered by the disputes would be contrary to Ofcom's duty as regards regulatory certainty.

## **IX. ORDERS FOLLOWING A FINDING OF OVERCHARGE**

245. As we have observed, BT's position in its appeal is not that there should have been no finding of overcharge. The various grounds discussed above are all directed at establishing that the overcharge should have been quantified at a significantly lower amount than was determined by Ofcom. However, irrespective of the level of overcharge, BT contends that Ofcom does not here have the power to order it to repay the overcharge: Ground 5 of BT's appeal. Alternatively, if Ofcom has such a power, BT argues that it erred in the exercise of its discretion to order repayment of the full amount of the overcharge in this case: Ground 6 of BT's appeal. In the Determination, Ofcom decided that it should not require BT to pay interest on the principal amount overcharged. Both Sky/TalkTalk and the Altnets contend that payment of interest could, and should, have been ordered: Ground 4 of Sky/TalkTalk's appeal and the sole ground of the Altnets' appeal.

## A. BT's Ground 5

246. This ground of BT's appeal raises an issue of jurisdiction. BT argues that the CRF restricts the power of Ofcom to order repayment of sums overcharged in breach of a cost orientation obligation, and that the 2003 Act is to be interpreted in accordance with the underlying EU legislation. BT accordingly described this ground as a "fundamental challenge" to Ofcom's analysis of its powers and Mr Thompson in his opening said it was "the key part of the case from the legal perspective."

247. BT does not contend that in the event that Ofcom finds an overcharge, no repayment at all can be ordered. The extent to which, on BT's case, Ofcom has jurisdiction to make such an order underwent a significant change in the course of the proceedings. In its Notice of Appeal, BT stated that Ofcom could not direct BT to make repayments relating to services "supplied and paid for without dispute". That was explained as follows:<sup>38</sup>

"For the purpose of this ground, 'without dispute' refers to circumstances where, in the context of an ongoing commercial relationship for the supply of Ethernet services, the Disputing CP has paid BT's charges without raising any formal challenge to their validity or compatibility with Condition HH3.1, for example by means of a letter or email formally raising the issue of cost orientation of the charges in question on a specific basis."

248. However, in its skeleton argument, BT stated that the power to order repayment is limited to the period from when the disputing CP that has negotiated in good faith, but failed to reach agreement, calls on Ofcom to resolve the dispute. This was clarified by Mr Thompson as meaning from the date on which Ofcom received the dispute.

249. The significant distinction between these alternatives is illustrated by the facts of the present disputes. For example, Sky/TalkTalk first raised a dispute with BT in January 2008, while the charges complained of were still current, but made a formal reference of the dispute to Ofcom only on 27 July 2010. Virgin disputed the charges with BT in October 2007, but referred the dispute to Ofcom on 10 August

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<sup>38</sup> Fn 214 to para 322 in BT's Notice of Appeal.

2010. In those cases, as indeed in the cases of CWW and Verizon, the disputes were referred to Ofcom after the period of alleged overcharging had ended: see the Table at para 7 above. Accordingly, on BT's final version of its case on jurisdiction, Ofcom here has no power to order repayment of the overcharges at all.

250. In the 2003 Act, sect 190 sets out the powers of Ofcom when it resolves a dispute:

“(1) Where OFCOM make a determination for resolving a dispute referred to them under this Chapter, their only powers are those conferred by this section.

(2) Their main power ... is to do one or more of the following—

(a) to make a declaration setting out the rights and obligations of the parties to the dispute;

(b) to give a direction fixing the terms or conditions of transactions between the parties to the dispute;

(c) to give a direction imposing an obligation, enforceable by the parties to the dispute, to enter into a transaction between themselves on the terms and conditions fixed by OFCOM; and

(d) for the purpose of giving effect to a determination by OFCOM of the proper amount of a charge in respect of which amounts have been paid by one of the parties of the dispute to the other, to give a direction, enforceable by the party to whom the sums are to be paid, requiring the payment of sums by way of adjustment of an underpayment or overpayment.”

251. Clearly, the language of sect 190(2)(d) contains no temporal limitation on the scope of a payment direction. However, BT submitted that as the dispute resolution provisions of the 2003 Act were implementing the CRF, according to well-established principles of EU law sect 190 should be interpreted so as to comply with the CRF, which does not permit such a direction.

252. BT's challenge was based on various provisions of the CRF. In particular, BT relies on Art 3(2) of the Authorisation Directive as establishing the proposition that no obligations may be imposed on a CP by the NRA – here Ofcom – save as expressly identified. It is appropriate to set out the material parts of Art 3:

“1. Member States shall ensure the freedom to provide electronic communications networks and services, subject to the conditions set out in this Directive. To this end, Member States shall not prevent an undertaking from providing electronic



communications networks or services, except where this is necessary for the reasons set out in Article 46(1) of the Treaty.

2. The provision of electronic communications networks or the provision of electronic communications services may, without prejudice to the specific obligations referred to in Article 6(2) or rights of use referred to in Article 5, only be subject to a general authorisation. The undertaking concerned may be required to submit a notification but may not be required to obtain an explicit decision or any other administrative act by the national regulatory authority before exercising the rights stemming from the authorisation. ...”

253. Art 5 there referred to concerns rights of use of radio frequencies. Art 6(2) identifies a number of specific obligations that may be imposed under other provisions of the CRF, the criteria for which should all be referred to in the general authorisation. Those specific obligations include Art 8 of the Access Directive, and thereby encompass all the SMP obligations in Arts 9-13.

254. It will be recalled that Art 13 of the Access Directive enables imposition of the SMP obligation, of price controls and cost orientation: see para 27 above. Art 13(3) includes the following provision:

“National regulatory authorities may require an operator to provide full justification for its prices, and may, where appropriate, require prices to be adjusted.”

255. BT accepts that Art 13(3) therefore confers power on a NRA to make a remedial order requiring an operator to change its current prices on a prospective basis. BT submits, however, that the provision does not cover charges paid previously. Apart from Art 13(3), BT contends that there is no provision in the CRF that allows a NRA to impose an obligation on an operator to make repayments for services supplied historically, i.e. before (on BT’s final case) a dispute was accepted by the regulator.

256. The role of the NRA in resolving disputes arising in connection with obligations under the CRF is governed by Art 20 of the Framework Directive. We set this out at para 30 above, but for present purposes it is appropriate to quote again Art 20(3):

“In resolving a dispute, the national regulatory authority shall take decisions aimed at achieving the objectives set out in Article 8. Any obligations imposed on an undertaking by the national regulatory authority in resolving a dispute shall respect the provisions of this Directive or the Specific Directives.”

257. In reliance again on Art 3(2) of the Authorisation Directive, BT submits that this language cannot permit the imposition in the context of dispute resolution of further obligations that go beyond the obligations expressly permitted under the CRF.
258. If BT's construction of the CRF were correct, it would have a bizarre result. BT does not contend that Ofcom had no jurisdiction to accept these disputes and assess the overcharge over the whole period complained of. On BT's case, therefore, Ofcom is entitled to accept and consider a dispute regarding compliance with a cost orientation or charge control condition over a period stretching back several years before the dispute was referred but, if it finds that the dominant provider has breached the condition and substantially overcharged the disputing CP, Ofcom may have no power to order repayment. In an attempt to address this rather surprising consequence of its case, BT points out that a disputing CP, which Ofcom found had been overcharged, could, with the consent of Ofcom, bring a civil action in the courts for recovery of the amount overpaid: see sect 104 of the 2003 Act. That is, however, a costly and complicated alternative to a direct regulatory power. Moreover, it is to be noted that recital (32) of the Framework Directive (see para 32 above) expressly envisages that dispute resolution by the NRA should be invoked only after the failure of a good faith negotiation. But on BT's revised case as to Ofcom's jurisdiction, however, a disputing CP would have no incentive to engage in the kind of detailed negotiation that might be required to resolve a dispute, since if the negotiations failed and Ofcom then found in the CP's favour, Ofcom would be precluded from directing repayment of the overcharges paid during the period of negotiation.
259. We consider that the fundamental fallacy in BT's approach to the legislation is its misapplication of the term "obligation". Art 3(2) of the Authorisation Directive is, significantly, a paragraph in the provision dealing with general authorisation. This concept is explained in recitals (7)-(9) of the Directive:

“(7) The least onerous authorisation system possible should be used to allow the provision of electronic communications networks and services in order to stimulate the development of new electronic communications services and pan-European communications networks and services and to allow service providers and consumers to benefit from the economies of scale of the single market.

(8) Those aims can be best achieved by general authorisation of all electronic communications networks and services without requiring any explicit decision or administrative act by the national regulatory authority and by limiting any procedural requirements to notification only. Where Member States require notification by providers of electronic communication networks or services when they start their activities, they may also require proof of such notification having been made by means of any legally recognised postal or electronic acknowledgement of receipt of the notification. Such acknowledgement should in any case not consist of or require an administrative act by the national regulatory authority to which the notification must be made.

(9) It is necessary to include the rights and obligations of undertakings under general authorisations explicitly in such authorisations in order to ensure a level playing field throughout the Community and to facilitate cross-border negotiation of interconnection between public communications networks.”

260. Art 3(2) therefore restricts the obligations that might be imposed on the provision of communications networks or services that could impede that general authorisation, such as any conditions or requirements that have to be satisfied for the provision of networks or services, or as to the form or manner in which, or the extent to which, those networks or services may be provided. It is in that regard that only expressly permitted obligations may be imposed. The decision in Case C-16/10 *The Number (UK) Ltd and Conduit Enterprises Ltd* [2011] ECR I-691, on which BT strongly relied, illustrates the point, since there the issue was whether Ofcom could impose on BT a universal service condition requiring it to make available on a wholesale basis to other providers of directory enquiry services its comprehensive telephone subscriber database. Having regard to Art 3(2) of the Authorisation Directive, the ECJ held that the national regulator could not impose such obligations, which went beyond the obligation to provide comprehensive directory inquiry services and directories to end users as expressly set out in the Universal Services Directive (which, like the SMP obligations, were obligations identified in Art 6(2) of the Authorisation Directive).

261. In our judgment, there is a basic distinction between such a regulatory obligation imposed by a NRA and the enforcement action that may subsequently be taken by the NRA following non-compliance with such an obligation. Where a CP has been found to have overcharged in breach of an obligation legitimately imposed, a direction that it should repay the excess does not involve a restriction or qualification or condition that affects its general authorisation to provide electronic communications services. Indeed, such a direction merely has the financial effect

(subject to the question of interest) of placing the defaulting provider in the position that it would have been in had it complied with the regulatory obligation which it has breached. We therefore reject the argument that such an order or direction involves submitting the communications provider to a new or specific “obligation” that is precluded by Art 3(2) of the Authorisation Directive.

262. We note in that regard that Art 10 of the Authorisation Directive, which addresses “own initiative” enforcement by a NRA of specific obligations, expressly enables the NRA, in certain circumstances, to impose a financial penalty on an undertaking that has failed to comply: Art 10(3). The requirement to pay a penalty obviously constitutes an additional obligation on the undertaking. But this was evidently not considered to be the kind of “obligation” referred to in Art 3(2) since Art 10 is not one of the provisions for which express authorisation is there provided. As for Art 20(3) of the Framework Directive, even if a direction to repay an overcharge is properly regarded as an “obligation” in that particular context, such a direction, in our view, clearly respects the provisions of the CRF since it is designed directly to remedy contravention of an obligation imposed pursuant to the CRF. This is indeed the purpose of dispute resolution, as explained by recital (32) to the Directive, quoted at para 32 above. We see nothing in the French and German language versions of Art 20(3), to which BT referred in its Reply, that affects this conclusion.

263. Accordingly, we find that sect 190(2)(d) of the 2003 Act, in giving an unrestricted power to Ofcom to direct repayment, is consistent with the CRF. There is no basis on which to read it “down” so as to limit that power to cover only charges paid after Ofcom received a dispute.

264. We have determined this issue on the basis of the language of the legislation, properly interpreted in its context. However, the matter has, in effect, been previously considered in the PPC case. There, the disputing CPs submitted requests to Ofcom on 25 June 2008 and 20 October 2008 to resolve disputes alleging that BT had overcharged them in respect of PPCs and seeking reimbursement. The period of alleged overcharging was from 24 June 2004 to 30 September 2008. By its determination, Ofcom held that BT had overcharged for

certain trunk services in the period 1 April 2005 to 30 September 2008 and directed BT to make repayment of the amount overcharged. Thus the entire period (or almost the entire period in the case of some of the disputes) covered by the order for repayment related to a time before the disputes were “received” by Ofcom.

265. Ofcom’s determination was upheld on appeal by this Tribunal, and a further appeal to the Court of Appeal was dismissed: see para 86 above. Before the Tribunal, BT’s challenge to Ofcom’s jurisdiction was decided as a preliminary issue: the “*PPC (preliminary issues) judgment*” [2010] CAT 15. BT argued that the dispute resolution procedure covered only “current” (or prospective) as opposed to “historical” disputes. Therefore, BT’s jurisdictional challenge was not limited, as here, to the power to order repayment but extended to the power to accept the dispute and determine the overcharge. Moreover, in arguing against a jurisdiction over a “historical” dispute, BT there formulated its case as excluding a dispute over charges relating to a time before a challenge had been made: i.e., the basis advocated in BT’s Notice of Appeal in the present case but abandoned in favour of a later cut-off date in its skeleton argument: paras 238-239 above.

266. The Tribunal firmly rejected BT’s argument, following an analysis of the provisions of the CRF and the 2003 Act. Noting that if it had been intended to exclude a certain class of dispute from the scope of dispute resolution, one would have expected that to be stated clearly, the judgment continued, at [93]:

“Yet the Directives and the 2003 Act contain no such clear distinction. Such a distinction would be all the more necessary given that the historical/non-historical distinction put forward by BT is by no means the only distinction that could be made regarding past, present and future disputes between communications providers.”

267. In its conclusions, the Tribunal noted the considerable practical inconvenience that would result from BT’s contention, specifically in its implication for the power to order repayment of overcharges, stating at [108(b)]:

“...there is a basic injustice in restricting OFCOM’s jurisdiction to that point in time when a party’s conduct is overtly challenged. To revert, once again, to our hypothetical example..., why should [the disputing CP] be confined to adjustments of underpayments or overpayments relating back only so far as date [on which it

first made its challenge, 30 days after the conduct began]? If OFCOM has determined that an adjustment should be made under section 190(2)(d), then OFCOM should have jurisdiction to order that such adjustment relates back to the date when the breach of the SMP condition began.... Any other approach would encourage pre-emptive and legally dictated challenges designed to extend OFCOM's jurisdiction, rather than the commercial approach that informs parties subject to the 2003 Act at present."

268. In the Court of Appeal, BT no longer submitted that Ofcom's jurisdiction excluded historical disputes but instead sought to argue that Ofcom's dispute resolution powers were implicitly limited to disputes which are likely to be completed within four months. The Court of Appeal refused permission to appeal on that ground, holding that it was not seriously arguable: judgment of Etherton LJ at [65].
269. It is correct that the jurisdictional argument was advanced before us on a rather different basis from the way it was put in the PPC (preliminary issues) case, and BT submitted that that case was decided *per incuriam*. But for the reasons we have set out above, we regard BT's case as wholly misconceived and we agree with, and respectfully adopt, the reasoning in the PPC (preliminary issues) judgment.
270. We should add, for completeness, that we see nothing in the *TRD* judgment of this Tribunal that affects this issue: *T-Mobile (UK) Ltd and Ors. v Ofcom* [2008] CAT 12. Nor do we see that any question of retrospectivity arises, as BT submitted in opening its appeal. Condition HH3.1 was imposed on 24 June 2004 and the periods of these disputes concern BT's charges following the imposition of that obligation. The periods also follow the coming into force of sect 190(2)(d) of the 2003 Act.

## **B. BT's Ground 6**

271. BT submits that if, contrary to its Ground 5, Ofcom has jurisdiction to order repayment, it was wrong to make such an order in this case. BT emphasises that the power to make an order under sect 190 is discretionary and argues that, in deciding to order repayment, Ofcom failed properly to assess and follow the

requirements of Art 8 of the Framework Directive, and failed to take account of relevant considerations or took account of irrelevant considerations.

272. However, as BT recognises in its Notice of Appeal (at para 426), the *PPC CA* judgment is of central importance to this Ground. There, BT argued, (as Ground 3 of its appeal), that Ofcom erred in law in directing BT to repay the full amount by which it found BT had overcharged. There, too, BT submitted that when exercising its power under sect 190 of the 2003 Act, Ofcom must have regard to the overall objectives of the Act and the CRF, and BT contended that a direction for repayment in that case had the effect of a penalty, not the provision of compensation. It further submitted that in deciding whether to order repayment, Ofcom should approach the matter by analogy with a claim for damages for breach of statutory duty or restitution for unjust enrichment.
273. This ground of appeal was firmly rejected by the Court of Appeal. It is appropriate to quote at some length from the judgment of Etherton LJ (with which Rix and Lewison LJ agreed):

“82. ... The object of the section generally is to confer power on Ofcom to enforce its determination of disputes referred to Ofcom pursuant to section 185 of the Act. The express purpose of section 190(2)(d) is to give effect to the determination by Ofcom of "the proper amount" of a charge and to do so by way of adjustment of any underpayment or overpayment.

83. It is common ground that Ofcom has a discretion in the exercise its powers under section 190. I do not accept Mr Saini's submission [for Ofcom] that the discretion is an "all or nothing" discretion: that is to say, in the case of excessive charging, either Ofcom must order repayment of the entire overpayment or it must decline to make any order for repayment. The statutory language does not expressly or impliedly require so extreme and inflexible a position. Nor is it logical for Parliament to have so intended. In exercising its remedial powers Ofcom will, as Mr Vajda said, be acting as a regulator giving effect to the statutory regime and, therefore, to the objectives of the CRF. That is not consistent with conferring an "all or nothing" power on Ofcom. It is, however, consistent with a discretion to make such order for repayment as will best achieve the objectives of the Act and the CRF on the particular facts of the case. Support for that is to be found in the word "adjustment" in section 190(2)(d), which is likely to have been intended to reflect the power of a NRA under Article 13(3) of the [Access Directive] to require prices to be adjusted "where appropriate".

84. The discretion under section 190 plainly must be exercised in a principled way with a view to achieving those objectives. The starting point must be, in a case of overcharging in breach of an SMP condition, to order repayment of the amount of the excess charge. If, however, the payee can show some good reason why a lesser

repayment or no repayment at all would better achieve the objectives of the Act and the CRF than that would provide a principled basis for Ofcom to give a direction for only a partial repayment or to make no direction for repayment at all. If the Tribunal, in describing Ofcom's discretion under section 190(2) as a "hard discretion" (in paragraph 182), intended to exclude such an approach by Ofcom, then I cannot agree. In any event, in the light of the arguments raised on behalf of BT on this appeal which I have rejected, and on the facts as found by the Tribunal, I can see no proper basis for reaching a different conclusion from both Ofcom and the Tribunal on the remedy they considered appropriate."

274. Etherton LJ proceeded, at [88], to note that Ofcom had found that the overcharging had adverse consequences for both the disputing CPs and their customers, and distorted the market. Overcharging for trunk segments in PPCs disadvantaged those CPs whose networks were more dependent on trunk segments and distorted the decisions of CPs as to whether or not to purchase trunk segments or self-supply, or indeed invest in PPCs at all. Accordingly:

"Both Ofcom and the Tribunal were perfectly entitled to conclude that it is not consistent with the regulatory regime and the objectives of the CRF to leave BT with the benefit of its excessive charging for trunk segments in breach of Condition H3.1 in the light of those economic consequences as well as the economic harm suffered by the ultimate retail customers."

Etherton LJ added that it was not an objection to a repayment order that the CPs may have passed on those higher charges to their customers.

275. In its present appeal, BT argues that Ofcom failed to exercise an independent discretion on the issue of repayment, as distinct from the issue of the 'proper amount of the charge'. But, as the Court of Appeal made clear, once Ofcom had determined that there was an overcharge, the starting point is that repayment of the amount of the overcharge should be ordered. It is for BT to show good reason why such an order should not be made. BT submitted that sect 190(2)(d) "does not create any presumption that this is the sum that *must* be ordered unless BT can provide a good reason to make a different order". However, as interpreted by the Court of Appeal, which is of course binding on this Tribunal, that is broadly the effect of the statutory provision. BT has been found to have obtained by its charges to the Disputing CPs monies that it should not have obtained. Prima facie, it should therefore not be allowed to retain those monies but should be required to pay them back, unless it can demonstrate "good reason" to the contrary.



276. Moreover, here, as in the *PPC* case, Ofcom expressly found that BT's excessive charges for BES and WES may have caused economic harm. The Disputing CPs' relative spend on WES and BES services will be different, and therefore retail competition between those CPs will have been distorted. To the extent that the higher charges were passed on through higher retail prices, end users paid more. Further, retail demand may have been suppressed or diverted to non-Ethernet based services, while prices above DSAC may have distorted CPs' investment decisions. See the Determination at paras 10.77-10.93.
277. The main reasons set out by BT as to why Ofcom should not have ordered repayment amount, in our view, to little more than recycling many of the points raised under its Grounds 1-3, on the basis that although those points had been rejected, because they were arguable or uncertain, Ofcom should not have ordered repayment of the overcharge calculated without taking them into account. We do not accept that approach.
278. Once Ofcom had, in our judgment very properly, refused to accede to those arguments, and established that BT had overcharged, those arguments do not resurface to provide a good reason why BT should retain the benefit of the overcharge. As Ofcom observed, allowing BT to keep that benefit could provide an incentive for it to fail to comply with its regulatory obligations, whereas requiring repayment promotes the interests of consumers and competition by ensuring that such SMP obligations are enforced: Determination, para 15.59. Moreover, in deciding to require BT to make repayment, Ofcom expressly had regard to the Community requirements in sect 4 of the 2003 Act, which give effect to the objectives set out in Art 8 of the Framework Directive: see Determination, paras 15.145-15.151.
279. We consider that BT has shown no good reason, either during the dispute resolution before Ofcom or to this Tribunal on appeal, why it should not be required to repay the amount which it overcharged. Following the approach in the *PPC CA* judgment, this ground of appeal accordingly fails.

**C. The Altnets' Appeal and Sky/TalkTalk's Ground 4**

280. In the Determination, Ofcom decided not to award interest on the amount of the overcharge required to be repaid, as sought by the Disputing CPs. The respective contracts between each Disputing CP and BT for the Ethernet service that was subject to the dispute all contain the following clause 12.3:

“... If any charge is recalculated or adjusted with retrospective effect under an order, direction, determination or requirement of Ofcom, or any other regulatory authority or body of competent jurisdiction, the Purchaser Parties agree that interest will not be payable on any amount due to either party as a result of that recalculation or adjustment.”

281. Ofcom noted that the Disputing CPs had not previously brought a dispute or complaint regarding clause 12.3, although it had been in place for some years, and concluded that:

“...the Disputing CPs have not provided strong and compelling evidence that clause 12.3 is not fair and reasonable such that we should intervene in the light of our regulatory objectives to set it aside” (Determination, para 15.144).

282. The appeal by the Disputing CPs against this part of the Determination took a somewhat unusual course. With their Notices of Appeal, the Disputing CPs filed witness statements concerning the circumstances of the negotiation of the contracts for the provision of BES and WES, to the effect that the Disputing CPs had little choice at the time but to accept clause 12.3. Ofcom by its Defence accepted that the Tribunal should have regard to this fresh evidence in considering whether interest should be awarded on the amount of repayment, and anticipated that BT might wish to file evidence in reply. On that basis, Ofcom expressly did not put forward any view as to whether interest should or should not be awarded: Defence, paras 545-546.

283. As anticipated by Ofcom, BT duly filed evidence giving its own account of the negotiations that led to clause 12.3, but by its Statement of Intervention in the appeals of Sky/TalkTalk and the Altnets, it took the fundamental point that Ofcom does not have jurisdiction to award interest under sect 190(2)(d) of the 2003 Act. And if, contrary to its primary position, Ofcom has such a jurisdiction, BT

supported Ofcom's decision in the Determination not make such an order in this case.

284. In its skeleton argument for the hearing of the appeals, dated 11 October 2013, Ofcom strongly disputed BT's submissions that it lacked jurisdiction to order interest, but did not address the challenge to its decision not to make such an award. However, on 25 October 2013, a few days before the start of the hearing of these appeals, Ofcom issued its determination in a dispute brought by Gamma Telecom Holdings Ltd ("Gamma") and BT regarding the provisions in BT's standard interconnection agreement ("SIA") that specified the interest rate applicable to any repayments required between the parties as a result of a direction by Ofcom (the "*Gamma* determination"). Ofcom there made a declaration under sect 190(2)(a) that the interest terms in the SIA are not fair and reasonable insofar as they relate to payment of interest where Ofcom has made a determination directing a payment under sect 190(2)(d). In an Annex to the Gamma determination, Ofcom further gave guidance on the approach it would adopt to interest in the context of resolving a dispute. In opening Ofcom's case to the Tribunal, Mr Saini stated that Ofcom no longer sought to support the reasoning in the Determination regarding interest but instead submitted that the correct approach was that which it had set out in the Gamma determination. Beyond that, Ofcom made no submissions on this issue.

285. Accordingly, the position under this ground of appeal was that:

- (a) BT submitted that Ofcom had no jurisdiction to award interest, which all the other parties disputed; and
- (b) If such jurisdiction existed, the question whether it should have been exercised to order payment of interest was essentially contested between BT on the one hand, and the Disputing CPs (drawing support from the Gamma determination) on the other hand.

(i) *Jurisdiction*

286. The powers of Ofcom in its determination resolving a dispute are exclusively those set out in sect 190(2) of the 2003 Act: see sect 190(1). Those provisions are to be interpreted in the light of the CRF.

287. It is common ground that there is nothing in the CRF that expressly requires or precludes a NRA having the power to award interest on any payment directed in the resolution of a dispute. It will be recalled that Art 20(3) of the Framework Directive succinctly states:

“In resolving a dispute, national regulatory authorities shall take decisions aimed at achieving the objectives set out in Article 8.”

Those objectives include the promotion of competition in the promotion of electronic communications networks and services, by *inter alia*, ensuring that there is no distortion or restriction of competition in the electronic communications sector: Art 8(2)(b). Further, we repeat for convenience recital (32) of the Framework Directive:

“The intervention of a national regulatory authority in the resolution of a dispute between undertakings providing electronic communications networks or services in a Member State should seek to ensure compliance with the obligations arising under this Directive or the Specific Directives.”

288. Sect 190(2)(d) enables Ofcom, when it finds that there has been an underpayment or an overpayment, to give a direction “requiring the payment of sums by way of adjustment of an underpayment or overpayment.” We see no good reason, on the ordinary reading of this language, why it does not enable that direction to include payment of interest. Where one party has for a time held money in a commercial setting that it should not have held, or which should have been paid to another party, it is trite to observe that the time value of the money is a part of the benefit obtained. Depending on the amount, the period involved and the applicable rate of interest, that time value can indeed be significant. If the “adjustment of an underpayment or overpayment” which Ofcom could direct excluded interest in any circumstances, the “adjustment” may therefore be only partial.

289. If necessary, this interpretation of the subsection is reinforced by the reference to “sums”, which Ofcom submitted indicated the statutory intention to cover a sum for the amount over or under paid and a sum in respect of interest. However, we recognise that a single dispute may be brought by a number of persons (as with Sky and TalkTalk here), so that a direction could involve payment of different amounts to different persons. We prefer to base our interpretation on basic principle, and a purposive rather than a literalist reading of the language. If the direction could never include interest, then a CP subject to a price control obligation would often have an incentive to overcharge since even if the overcharge were subsequently discovered and repayment ordered, the CP would know that it could nonetheless retain the income benefit of the money improperly charged. In our view, therefore, a repayment order that included interest on the overpayment may often be a decision that better achieves “the objectives set out in Article 8”, and serves to ensure compliance with SMP charge control obligations, than a decision confined to repayment of only the principal amount. Where an award of interest is required in order best to achieve those objectives, the statutory language should be read as giving Ofcom the power to make such an award.
290. Further, we note that Ofcom could under sect 190(2)(b) give a direction fixing a term in BT’s contract with a CP as to its obligation to pay interest in the event that Ofcom found an overpayment. That indeed was the subject of the Gamma dispute. Since Ofcom can therefore determine ex ante that interest should be paid in that eventuality, it would be very surprising if, when the eventuality ensued (without such a direction having been made), Ofcom was precluded from directing payment of interest. We do not accept that the statute is intended to produce such an inconsistent position.
291. We should add that we did not find the references by BT in its skeleton argument to various other domestic statutes to be of assistance. The essence of BT's argument was that where Parliament intends interest to be available, it makes express provision to that effect. The references relied on by BT were, however, addressing entirely different situations. The language of sect 190 of the 2003 Act is to be interpreted in its particular context and in light of the CRF.

(ii) *Whether interest should be ordered*

292. As set out above, in the Determination Ofcom based its decision not to award interest on clause 12.3 of BT's contracts with the Disputing CPs. Ofcom does not now seek to uphold that ground, and we consider it is correct not to do so.
293. In argument, both Sky/TalkTalk and the Altnets relied on aspects of the Court of Appeal judgment *Telefónica O2 UK Ltd v BT* [2012] EWCA Civ 1002 (the "*08x Numbers* case"). An appeal against that judgment was pending and, very recently, the Supreme Court issued its judgment reversing the Court of Appeal's decision: *BT v Telefónica O2 UK Ltd* [2014] UKSC 42. BT, with the Tribunal's permission, made supplementary written submissions on the implications of the Supreme Court's judgment, which we have taken into account in reaching our decision.
294. In the *08x Numbers* case, Lord Sumption, giving a judgment with which all the other members of the Court agreed, made some observations regarding the nature of dispute resolution by Ofcom. To appreciate the context, it is necessary to explain briefly the circumstances of the *08x Numbers* case. Art 4(1) of the Access Directive requires operators of public communications networks to negotiate with each other for the purpose of providing interoperability of services, and that they shall offer interconnection on terms and conditions consistent with obligations imposed by the NRA. Art 5 deals with the powers and responsibilities of NRAs with regard to access and interconnection. Art 5(4) of the Access Directive provides:
- “With regard to access and interconnection, Member States shall ensure that the national regulatory authority is empowered to intervene at its own initiative where justified [or, in the absence of agreement between undertakings, at the request of either of the parties involved,]<sup>39</sup> in order to secure the policy objectives of Article 8 of Directive 2002/21/EC (Framework Directive), in accordance with the provisions of this Directive and the procedures referred to in Articles 6 and 7, 20 and 21 of Directive 2002/21/EC (Framework Directive).”
295. The case involved appeals against Ofcom's determinations of several disputes referred by mobile network operators (“MNOs”) about BT's proposed increases in termination charges for calls to non-geographic numbers (0800, 0845 and 0870

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<sup>39</sup> The words in parenthesis were removed by Dir 2009/140/EC.

calls). That did not concern a market in which BT had SMP. BT sought to increase its charges pursuant to a contractual term in its Standard Interconnect Agreement (“SIA”) with MNOs. However, the SIA provided that the MNO may dispute the proposed variation in charges, and if that does not produce an agreed solution the dispute may be referred to Ofcom. Lord Sumption held that although the SIA purported to give BT a discretion to vary its charges, the SIA must be interpreted as intending to comply with the regulatory background: therefore BT’s discretion was limited by reference to the purposes set out in Art 8 of the Framework Directive. BT’s right to set its own charges was contractually subject to any order, direction or determination by Ofcom. In those circumstances, he held (at [38]):

“In this case, therefore, Ofcom’s function was to determine whether BT’s proposed charges exceeded the limits of its contractual discretion. That depends on whether they were in fact consistent with the Article 8 objectives.”

296. Earlier in his judgment, Lord Sumption addressed the function of Ofcom in resolving disputes. It is appropriate to quote [31]-[34] of the judgment:

“31. The dispute resolution functions of Ofcom have often been described as regulatory, notably by the CAT in *T-Mobile (UK) Ltd v Office of Communications* [2008] CAT 12. It is unquestionably true that the dispute resolution functions of national regulatory authorities are part of the regulatory scheme, and that in exercising those functions the regulator is required by Article 20.3 of the Framework Directive to promote the overarching objectives set out in Article 8, just as it is required to do in exercising its other functions. But the description of dispute resolution as "a form of regulation in its own right" is apt to mislead without some analysis of what is meant by it.

32. As a national regulatory authority charged with the resolution of disputes, Ofcom has both regulatory and adjudicatory powers. Article 20.1 of the Framework Directive requires national regulatory authorities to have power to resolve disputes between CPs "in connection with obligations arising under this Directive or the Specific Directives between undertakings." Article 5.4 of the Access Directive requires national regulatory authorities to have a power of intervention in a dispute about access and interconnection in accordance with (inter alia) the procedures in Article 20 of the Framework Directive, in order to secure the policy objectives of Article 8 of the Framework Directive. The combined effect of these provisions is that the dispute resolution function extends to disputes of different kinds. A dispute may arise (i) under the existing interconnection terms, or (ii) because the parties have been unable to agree terms and one of them wants the regulator to impose them, or (iii) because there are binding terms but they do not satisfy (or no longer satisfy) Article 5.3 of the Access Directive or the policy objectives in Article 8 of the Framework Directive. In case (i) it may perform an adjudicatory or a regulatory role or a combination of the two. The existence side by side of both adjudicatory and regulatory functions follows from the scheme of the Directives, but is

particularly clearly spelled out in section 190 of the Communications Act, which I have already quoted. The section distinguishes between Ofcom's powers in the course of dispute resolution to declare the rights and obligations of the parties (section 190(2)(a)), to fix the terms of transactions between the parties (section 190(2)(b)) and to impose an obligation to enter into a transaction on terms fixed by Ofcom (section 190(2)(c)). The first of these powers is plainly adjudicatory. The second and third are regulatory.

33. As I have pointed out above, the scheme of the Directives depends critically on the agreed interconnection terms. This is a feature of the scheme which is fundamental to its essentially permissive character. It reflects the consistent emphasis in the Directives on respecting freely negotiated interconnection terms in a competitive market: see in particular Recital (5) of the Access Directive. In the ordinary case, the interconnection terms will have been negotiated between the parties, within the constraints imposed by law, namely that the result must be consistent with the objectives in Article 8 of the Framework Agreement. If, however, they were imposed or modified by Ofcom under Article 5.1, the effect is the same, namely to create a contract or something that will be treated as legally equivalent to a contract.

34. When Ofcom is resolving a dispute about a proposed variation of charges under an existing agreement, it is performing a mixture of adjudicatory and regulatory functions. The terms of the interconnection agreement are the necessary starting point for this process. If there is no contractual right to vary the charges, it is difficult to see how Ofcom can approve a variation unless it is necessary to achieve end-to-end connectivity (for example to enable operators to recover their efficient costs) or to achieve the Article 8 objectives. If there is a contractual right to a variation, but the proposed variation is not consistent with the Article 8 objectives, Ofcom may reject the variation. It may also modify any terms which created an entitlement inconsistent with the Article 8 objectives. If there is a contractual right to a variation which is consistent with the Article 8 objectives, Ofcom's function when the right is challenged is to give effect to it."

297. As Lord Sumption there observed, statutory dispute resolution by Ofcom covers disputes of very different kinds. The three examples which he gives are clearly not intended to be exhaustive. The present case indeed concerns a dispute of a wholly different nature: whether a party subject to an SMP obligation has complied with that obligation. Since the SMP obligation was imposed as part of Ofcom's regulatory function, applying Lord Sumption's characterisation, Ofcom is clearly performing a regulatory function when resolving a dispute which concerns the proper interpretation and application of that SMP obligation. Ofcom's determination of that question does not involve consideration of any terms agreed between the parties. It is only once that determination has been made, and Ofcom considers what direction to make under sect 190(2)(d) for the purpose of giving effect to the determination, that the contractual terms agreed between BT and the Disputing CPs are engaged. However, since the primary determination regarding



compliance with the SMP obligation is the exercise of a regulatory role, we consider that in deciding what direction to make under sect 190(2)(d) to give effect to that determination, Ofcom is also exercising primarily a regulatory function.

298. Recital (32) of the Framework Directive, addressing the objective of dispute resolution, states:<sup>40</sup>

“The intervention of a national regulatory authority in the resolution of a dispute between undertakings providing electronic communications networks or services in a Member State should seek to ensure compliance with the obligations arising under this Directive or the Specific Directives.”

In our judgment, the question of whether or not to direct a payment of interest should therefore be determined according to what will best ensure compliance with the SMP obligations imposed under Art 13 of the Access Directive and promote the objectives of Art 8 of the Framework Directive. We accordingly accept the submission of Sky/TalkTalk that, in the circumstances of this case, clause 12.3 and the maintenance of commercial certainty are relevant only to the extent that they feed in to these central objectives of the CRF.

299. In resisting that approach, BT submitted that the Supreme Court held that there was “a clear presumption in favour of respecting ‘freely negotiated interconnection terms’”, relying on Lord Sumption’s judgment at [33]. However, what Lord Sumption there referred to was “the consistent emphasis in the Directives on respecting freely negotiated interconnection terms *in a competitive market*” (our emphasis). That was supported by his reference to Recital (5) of the Access Directive that explicitly addresses the position in “an open and competitive market”, in contrast to Recital (6) that refers to “markets where there continue to be large differences in negotiating power between undertakings, and where some undertakings rely on infrastructure provided by others for delivery of their services”.
300. Unlike the situation in the *08x Numbers* case, in the AISBO market BT has been found to have enjoyed SMP at the time that it entered into its contracts with the Disputing CPs, and thus negotiated clause 12.3. That finding of SMP has not been

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<sup>40</sup> The full text of Recital (32) is set out at para 32 above.

challenged. SMP is defined in Art 14(2) of the Framework Directive as a position equivalent to dominance:

“that is to say a position of economic strength affording it the power to behave to an appreciable extent independently of competitors, *customers* and ultimately consumers” [emphasis added].

Accordingly, the AISBO market was not a competitive market, and we do not consider that the *08x Numbers* judgment, properly read, indicates any presumption in favour of the contractual provision in this case.

301. In the *Gamma* determination, Ofcom set out at para 3.15 three “key potential objectives” that an award of interest might seek to achieve:

- “(a) **Objective 1:** avoid CPs having an incentive to set charges that are unduly high;
- (b) **Objective 2:** avoid CPs having an incentive to delay submitting disputes; and
- (c) **Objective 3:** avoid distorting CPs’ incentives to invest”.

In the present context, (a) refers to the incentives on BT, and (b) refers to the incentives on the Disputing CPs.

302. We agree that these are appropriate considerations in determining whether to award interest, having regard to the regulatory objectives to which we have referred. Indeed, in their experts’ joint statement on the question of interest, submitted for these proceedings before the *Gamma* determination was issued, Dr Maldoom and Dr Houpis agreed that these were the three incentive effects that in theory could be affected by the approach to repayment. Insofar as the contractual clause precluding interest is inconsistent with the achievement of those objectives in the circumstances of this case, Ofcom’s decision is not constrained by the contractual provision.

303. As regards the incentives on BT, Dr Maldoom and Dr Houpis further agreed that in the absence of payment of interest BT has a weaker incentive to comply with its cost orientation obligation. Apart from urging that this has to be balanced in practice against the two other objectives, Dr Maldoom considered that there were

other incentives that operated to encourage BT to comply, in particular BT's exposure to civil claims under sect 104 of the 2003 Act. However, a claim under sect 104 is for damages and can only be brought for the loss that a CP has suffered, which may be much less than the overcharge in the event that a CP passed it on to its retail customers, who in practice are unlikely to sue. It is striking that to date no claims under sect 104 have been brought, although a large number of disputes have been submitted to Ofcom. And the simple fact is that in the present case, notwithstanding any such risk of civil claims, BT did overcharge by a substantial amount over a number of years. Even if BT's appeal on its Grounds 1 or 2 were successful, on the calculations put forward by BT in its Notice of Appeal it accepts that it overcharged by at least £29.5 million; and, if there were no offsetting of charges below DSAC against those above DSAC, the figure rises to £61.7 million: paras 471-472. As Ofcom observed in its Defence (at para 118):

“... it does not appear that BT had at any stage developed a robust or well-justified means of demonstrating compliance with its cost orientation obligations.”

304. We think that the facts clearly demonstrate that the incentives on BT (referred to by Dr Maldoom) were inadequate in this case, and that the additional incentive to avoid overcharging that an award of interest provides is entirely appropriate.
305. As regards delay in submitting disputes, Dr Maldoom advanced the opinion that if interest were awarded on such overpayments, the overcharged CPs would have an incentive to delay bringing disputes to Ofcom. They would be able to pass on the overcharge to their customers over the period of delay, and then when a dispute was later referred the award of interest would provide them with a windfall. This theoretical analysis, advanced with little qualification in Dr Maldoom's reports, ignored a number of considerations and, in any event, broke down against the evidence in this case.
306. In his second report, Dr Maldoom explained how his opinion was based on the view that all competing CPs can increase their prices to reflect BT's higher wholesale charges. However, in cross-examination, Dr Maldoom had to accept that his opinion about CPs' incentives depended on the extent to which all rival CPs in the downstream market were dependent on the overcharged product. Here,

BES products are not used by Verizon at all and are not purchased to an appreciable extent by Virgin or BT Retail, but they are competitors in the downstream market of other CPs that do purchase BES. That downstream, retail market is a competitive market. Therefore if BT puts up its charges for BES, those CPs that need BES to reach their customers, such as Sky and TalkTalk, cannot necessarily put up their own charges to pass on their higher costs, because some of their competitors on the retail market will not be affected by BT's higher wholesale charges. Dr Maldoom had to acknowledge that at least BT was competing in the supply of these retail services throughout the UK and that Virgin self-supplied by building out fibre. What economists refer to as the "firm-level elasticity effect" would therefore provide a significant incentive for the disadvantaged firms to bring a dispute.

307. Further, any delay incentive is dependent on there being minimal 'volume' effects, or market-level elasticity. Even if all CPs purchased the overcharged products, it would not be in their interests to raise their retail prices to a corresponding extent if that caused consumers to switch away to other products. In cross-examination, Dr Maldoom accepted that the greater this volume effect, the weaker the incentive to delay bringing a dispute, and explained that this was not something he had attempted to assess.
308. In the *Gamma* dispute, BT similarly advanced the contention that awarding interest (or in that case, a more commercial rate of interest) would give CPs an incentive to delay bringing a dispute to Ofcom. Both the market-level elasticity effect and the firm-level elasticity effect are discussed in the *Gamma* determination as factors which make such an incentive implausible: paras 3.42-3.46. Moreover, as Ofcom there points out, a CP that for commercial reasons deliberately delayed bringing a dispute, runs the risk that Ofcom not only may award no interest but may not direct repayment of the full amount of the overcharge:

"3.47 As explained above, when setting the principal our starting point is generally that it should reflect the amount of the overcharge. However, where a lesser repayment may better achieve the objectives of the 2003 Act or the CRF, we may where appropriate reduce the principal (or indeed conclude that no repayment is necessary). This suggests that, even if the size of the overcharge were larger than

the loss suffered by an overcharged CP, it is not guaranteed that the repayment will be larger. Put another way, a CP may not be confident that it is profitable to delay bringing a dispute if it is concerned that the principle repayment sum might not reflect the full amount of the overcharge.”

309. The factual evidence from the Disputing CPs directly contradicted BT’s assertions about an incentive to delay bringing disputes. Mr Scott, who now works for Vodafone since it acquired CWW where he was previously involved in regulatory accounting, explained that CWW’s priority where it had been overcharged was to recover the amount of the overcharge as quickly as possible. Among other reasons, this was because:

“13.3 [C]orrect pricing is required to inform C&W’s cost and business strategies. This is of particular importance when pitching for new customer business. In instances where prices are expected to fall – for example, where there is an investigation into pricing of a particular service – C&W will come under pressure to factor that price fall into the bids which are being submitted at that time. However, C&W would only be in a position to factor the price decrease into a bid if the decrease was certain. Therefore, sitting on a dispute does not help C&W conduct daily business, where pricing certainty is essential; and

13.4 [U]ntil the point when Ofcom determines that an overcharge has occurred following a breach of cost orientation conditions, such as in this case, BT will be trading at a competitive advantage to the other CPs in the market. The higher wholesale prices will negatively affect CPs’ profitability and ability to compete with BT’s downstream arm.”

310. Mr Scott explained that while resources might delay CWW pursuing a dispute, the potential for an award of interest was not a factor. Mr Higo of Sky and Mr Heaney of TalkTalk both gave evidence of how they sought to progress the present dispute in negotiations with BT after their companies became aware of the overcharging, and how the delays in those discussions had nothing to do with considerations concerning interest.
311. As regards the third objective, concerning CPs’ investment incentives, Dr Maldoom suggested that the potential availability of more generous repayment terms in the event of an overcharge being discovered “creates a risk that BT may ‘over-comply’ by setting prices that could be too low to encourage efficient infrastructure investment by competitors”; and that BT itself may respond by choosing “to mitigate the risk of incorrectly being found to [have] overcharged for

services (especially where services are nascent) by delaying or not investing in such products” (Experts’ joint statement at point 3).

312. The same arguments were put forward by BT in the *Gamma* dispute, where Ofcom dismissed them as unlikely and implausible. We agree: they amount to a theoretical speculation wholly unsupported by any evidence, and as regards CPs’ investment decisions they again ignore the firm-level elasticity effect.

313. In the Annex to the *Gamma* determination, setting out guidance on its approach to interest, Ofcom expressed its “starting point” as follows (at para A2.3):

“In our view, it is likely to be appropriate to award interest in the majority of cases in which a direction for repayment is considered appropriate in order to avoid creating an incentive for CPs to set charges that are unduly high (in the absence of evidence to the contrary). Doing so is likely to meet our statutory duties in most cases. In particular, our main objective of avoiding CPs having an incentive to set unduly high charges is likely to benefit customers.”

314. It is not appropriate to express a view as to whether that approach is appropriate in all circumstances. In a competitive market, regard must now be had to the considerations set out in the *08x Numbers* judgment of the Supreme Court. But we consider that the approach which Ofcom there articulated is relevant and amply justified on the facts of the present case. Mr Coulson, who was called by BT as an independent expert witness but who for five years prior to 2011 worked in a senior role in the regulatory finance team at BT, was asked how the regulatory activity that led to the preparation of BT’s RFS interacted with the actual pricing of the regulated products:

“Mr Saini: What was the dialogue between the regulatory finance team, of which you were, at one point, head, and those people who were costing the products? In other words, was there ever a dialogue where the regulatory finance team would say: “It looks like DSAC has been exceeded in this past year, and we ought to be concerned from a regulatory point of view about the future [pricing]of our products?”

...

Mr Coulson: My memory of the events at the time is that there was not such a dialogue ... it was remarkable, actually, looking back that there was not the focus on DSAC and the linkage between what the pricing teams were doing and the regulatory finance team was actually quite absent .

...

Mr Coulson: Ethernet at the time, the key pricing decisions were being made by the pricing team within Openreach. I refer to them as the “pricing team” I’m not sure what the exact term was.

Mr Saini: And is it your evidence based on your factual knowledge at the time, that there was no dialogue going on between regulatory finance and the pricing team as regards cost orientation?

Mr Coulson: That’s correct.”

315. Although we heard contested evidence from a number of witnesses regarding the circumstances in which clause 12.3 came to be included in the contracts between BT and the Disputing CPs, we do not think it is necessary to resolve that matter. Not only, as we have pointed out, did BT have SMP in the market for Ethernet services which it was agreeing by those contracts to provide, but any consideration of commercial certainty is, in our view, of minimal significance in this case, given the fact that the conduct of BT indicated that it felt little incentive to comply with its cost orientation obligations in the pricing of its BES and WES products. We have no doubt that the Determination should therefore have included a direction to pay interest.

## **X. CONCLUSION**

316. Accordingly, for the reasons set out above:
- (a) we allow BT’s appeal as regards the adjustment to BT’s rental costs in respect of the exclusion of excess construction costs; and
  - (b) we allow Sky/TalkTalk and the Altnets’ appeals as regards the payment of interest.

In all other respects, the appeals of BT and Sky/TalkTalk are dismissed.

317. The parties are invited to make written submissions as to the appropriate directions that the Tribunal should make in the light of this judgment, including whether the Determination should be remitted to Ofcom under sect 195(4) of the 2003 Act to determine the appropriate rate of interest to be applied in calculating the total amount that BT is directed to pay to each Disputing CP.

The Honourable Mr  
Justice Roth

Stephen Harrison

Colin Mayer

Charles Dhanowa OBE, QC (Hon)  
Registrar

Date: 1 August 2014



## APPENDIX

### Extract from first report of Dr George Houpis

#### **“B. How such a test can be implemented in practice?”**

- 4.12 In this section I provide an indication of how the FAC based test can be implemented in Practice
- 4.13 The first step would be to apply DSAC as a first stage test of excessive pricing on an individual service basis for those services in dispute, based on the approach adopted in Ofcom’s Statement.
- 4.14 The next consideration is the appropriate level of grouping for the application of the second stage FAC based test. Based on the criteria set out above, the proposed grouping is the “Ethernet Services” grouping (i.e. WES and BES services together with main link products).
- 4.15 To apply the second stage FAC based test, it is necessary to arrive at the prices of the services the test should be based on. For those services which failed the first stage DSAC test at the individual service level, the prices for the second stage FAC based test would be ‘imputed’ at the DSAC level. The total (imputed) revenues for the chosen group of services would then be calculated based upon these imputed prices for the services that failed the first level test, and actual prices for the other services. For example, assume that the group of WES/BES services includes three products, WES1, BES2 and BES3, with the following prices, DSACs, and FACs:

4.15.1 WES1: Price of 15, DSAC of 10, and FAC of 7

4.15.2 BES2: Price of 12, DSAC of 10, and FAC of 7

4.15.3 BES3: Price of 8, DSAC of 10 and FAC of 7

The imputed price for WES1 is 10, and for BES2 also 10. If one unit of each product was sold, then the total imputed revenue for the second stage FAC based test would be 28 (10 + 10 + 8), and would be significantly higher than the FAC of 21.

- 4.16 If this imputed revenue was persistently and significantly above the FAC for this group of services, then this would indicate that prices were not cost orientated. As with the first stage individual product DSAC test some flexibility would be needed when applying this second stage test regarding the persistence of prices above FAC.

4.17 Calculating overcharges requires estimates of the prices that would apply in the counterfactual<sup>41</sup> that BT had met the cost orientation condition:

4.17.1 if a service fails the first stage DSAC test at the individual service level but the group of services does not fail the FAC test, then the counterfactual is that prices would have been set at DSAC.

4.17.2 if the group of services fails the second stage FAC test, a practical and simple approach would be to apply a simple common percentage reduction to *all prices* (including any imputed prices at DSAC because they failed the first test) to calculate the counterfactual prices for the purposes of determining overcharges. Using the illustrative example above, the percentage to apply to the price of each service to obtain the imputed price would be given by the ratio of FAC to imputed revenues:  $21/28=75\%$ . The prices for each service therefore in the counterfactual of compliance with the cost orientation obligation would be:

- (A) WES1 (imputed ratio (0.75) x DSAC (10)) = 7.5
- (B) BES2 (imputed ratio (0.75) x DSAC (10)) = 7.5
- (C) BES3 (imputed ratio (0.75) x actual price (8)) = 6

4.18 The calculation of the overcharges would then be the sum of:

4.18.1 The overcharges as a result of the application of the first stage DSAC test. In the illustrative example, these would be equal to 7 ( $5 + 2 = 7$ ); and

4.18.2 The overcharges as a result of the application of the second stage FAC based test. In the illustrative example, these would be equal to 7 ( $2.5 + 2.5 + 2$ ).

4.19 The total amount of overcharging in the illustrative example would therefore be 14.”

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<sup>41</sup> It is necessary to determine prices per service, as different CPs purchase different volumes of the disputed services.